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SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SACRAMENTO

CALIFORNIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM,

Plaintiff,

vs.

AOL TIME WARNER INC., AMERICA ONLINE,
INC., TIME WARNER, INC., RICHARD D.
PARSONS, R.E. TED TURNER, STEPHEN M.
CASE, GERALD M. LEVIN, ROBERT W.
PITTMAN, J. MICHAEL KELLY, KENNETH J.
NOVACK, DANIEL F. AKERSON, JAMES L.
BARKSDALE, STEPHEN F. BOLLENBACH,
FRANK J. CAUFIELD, MILES R. GILBURNE,
CARLA A. HILLS, REUBEN MARK, MICHAEL A.
MILES, FRANKLIN D. RAINES, FRANCIS T.
VINCENT, JR., DAVID COLBURN, ERIC KELLER,
RAYMOND J. OGLETHORPE, JANICE BRANDT,
JOSEPH A. RIPP, BARRY M. SCHULER, GEORGE
VRADENBURG, III, JAMES W. BARGE,
KENNETH B. LERER, WILLIAM J. RADUCHEL,
MAYO S. STUNTZ, JR., WAYNE H. PACE, PAUL
D. CAPPUCIO, MYER BERLOW, STEVEN
RINDER, CITIGROUP INC., SALOMON SMITH
BARNEY INC., MORGAN STANLEY & CO.,
BANC OF AMERICA SECURITIES LLC, J.P.
MORGAN CHASE & CO., ERNST & YOUNG LLP
and DOES 1-100, inclusive,

Defendants.

Case No.

COMPLAINT FOR:

- (1) VIOLATIONS OF §§11 AND 12 OF THE SECURITIES ACT OF 1933;
- (2) VIOLATIONS OF CAL. CORP. CODE §§25400-25403, 25500-25502, 25502.5, 25504, 25504.1 AND 25504.2;
- (3) VIOLATIONS OF CAL. CIVIL CODE §§1572, 1573, 1709, 1710 AND CAL. CORP. CODE §1507; AND
- (4) COMMON LAW FRAUD

DEMAND FOR JURY TRIAL

Exempt from Filing Fees
(Gov. Code § 6103)

INTRODUCTION

1. California Public Employees' Retirement System ("CalPERS") brings this action for violations of the Securities Act of 1933 (the "Securities Act"), California state law and the common law to redress the large losses it has suffered as a result of the Defendants' systematic and fraudulent scheme to materially inflate advertising revenue reported in the companies' publicly disclosed financial statements and, in turn, the value of America Online, Inc. ("AOL") and AOL Time Warner ("AOL Time Warner" or the "Company") securities. Specifically, Defendants overstated AOL's reported advertising revenue by at least \$1.7 billion through the use of sham transactions and improper accounting practices in order to ensure the consummation of the \$200 billion merger between AOL and Time Warner, Inc. ("Time Warner") announced in January 2000.

2. AOL appeared to be a successful company and was an attractive merger partner because of its large subscriber base and what appeared to be substantial advertising revenues. The advertising revenues were especially significant to AOL as its subscription revenues began to decrease in the late 1990s when it moved to fixed subscription charges (instead of per hour). However, by the end of the 1990s, the internet boom died, bringing down many of AOL's advertising customers. As a result, AOL's revenues began to slow dramatically. Instead of admitting this, AOL began to look for a merger partner to mask its declining business and keep the value of AOL stock at record levels long enough for AOL insiders to cash out their personal holdings.

3. On January 10, 2000, AOL and Time Warner announced their agreement to merge the two companies (the "Merger"). The value placed on AOL's stock for purposes of the Merger was based primarily on AOL's purported advertising revenue, and the tremendous growth AOL touted as to this revenue source.

4. In connection with the Merger, AOL and Time Warner filed a Registration Statement and Joint Proxy Statement-Prospectus (the "Merger Registration Statement"). As described below, the Merger Registration Statement contained materially false and misleading statements and omissions.

1 5. The Merger was not completed until January 11, 2001. During the year between
2 the announcement of the Merger and its consummation, the advertising market was continuing to
3 soften and more Internet companies began to fail. Despite this, the AOL Individual Defendants
4 assured the market that, unlike the rest of the industry, AOL was unaffected. At the same time,
5 however, internal AOL documents and discussions between Defendants during the pendency of
6 the Merger specifically apprised the Individual Defendants that AOL's advertising revenues
7 were going to decline by at least \$140 million for calendar year 2001 alone.

8 6. In order to keep up the facade during the one year period before the Merger was
9 finalized, AOL artificially inflated its publicly reported advertising revenue. After the Merger,
10 the Individual Defendants continued to overstate AOL Time Warner's advertising revenue to
11 bolster the Company's stock price and make it appear that both the Merger and the value of AOL
12 stock exchanged in the Merger were justified. Even when the advertising market eventually
13 became so weak that the Company was forced to report decreases in advertising revenue, it
14 nonetheless continued to artificially inflate its advertising revenue to soften the stock market's
15 reaction to the reported revenue numbers. Largely as a result of declining advertising revenue
16 figures, AOL has been forced to write-down over \$54 billion in goodwill -- the largest write-
17 down in corporate history.

18 7. On July 18 and 19, 2002, *The Washington Post* published a two-part article
19 reporting allegations that AOL before the Merger, and AOL Time Warner after the Merger, had
20 substantially overstated publicly reported advertising revenue. Within hours after *The*
21 *Washington Post* first reported the story, Defendant Robert W. Pittman, AOL Time Warner's
22 Chief Operating Officer, a member of the Company's Board, the head of operations for the AOL
23 division of the Company, and formerly the President and Chief Operating Officer of AOL prior
24 to the Merger, resigned from the Company. At the same time, the Company and Defendant Ernst
25 & Young, AOL's and AOL Time Warner's independent auditing firm, emphatically denied any
26 wrongdoing and reaffirmed the accuracy of AOL's and AOL Time Warner's financial
27 statements.

1 8. However, after the close of the stock market on July 24, 2002, the Company
2 acknowledged that the SEC was investigating AOL and the Company's accounting practices,
3 driving AOL Time Warner's stock price down by almost 15.4% overnight. On July 31, 2002, the
4 Company confirmed that the DOJ had commenced a criminal investigation of AOL and the
5 Company's accounting practices.

6 9. Two weeks later, on August 14, 2002, the Company acknowledged that
7 advertising revenue "may" have been overstated for AOL in the amount of \$49 million with
8 respect to three transactions covering a period of six quarters. The Company also stated that it
9 was "continuing its review of these and other transactions at the AOL division."

10 10. On October 23, 2002, the Company restated the financial statements of AOL and
11 AOL Time Warner for eight consecutive quarters (July 1, 2000 to June 30, 2002), a clear
12 admission of repeated violations of the securities laws. In fact, in its October 23, 2002 Form 8-K
13 filing with the SEC, AOL Time Warner not only restated the companies' advertising revenue by
14 reducing it in the amount of \$190 million, it also warned investors that the Company's
15 previously issued financial statements should no longer be relied on, including the audited
16 financial statements for 2000 and 2001 contained in the Company's Form 10-K for the year
17 ended December 31, 2001.

18 11. On March 28, 2003, the Company reported in its Form 10-K filing that it may
19 further restate AOL advertising revenue by reducing it in an additional amount of up to \$400
20 million for the years 2001 and 2002. According to the Company, this possible restatement is
21 attributable to two transactions with Bertelsmann AG, which are a subject of the SEC's
22 investigation. The Company also stated that, in addition to the Bertelsmann transactions, "it is
23 possible that further restatement of the Company's financial statements may be necessary," with
24 respect to "the range of other transactions" being investigated by both the SEC and the DOJ.

25 12. In the aggregate, the Company has thus far restated or acknowledged the
26 possibility of restating advertising revenue by reducing the revenue in the amount of at least
27 \$477 million, with essentially all of the reduction attributable to AOL advertising revenue.
28 However, according to the Amended Complaint filed in the related class action lawsuit (the

1 “Class Action Complaint”), Defendants actually overstated AOL’s advertising revenues by at
2 least \$1.7 billion.

3 13. Examples of Defendants’ illegal conduct during the relevant period include, but
4 are not limited to, the following:

5 (a) Sixteen separate sham transactions involving AOL and then AOL Time
6 Warner, Homestore, Inc. and various third parties, whereby AOL Time Warner improperly
7 reported significant advertising revenue;

8 (b) Various other sham transactions, including one with PurchasePro.com,
9 Inc., which was referred to in the July 19, 2002, *Washington Post* article as “science fiction;”

10 (c) This sham deal involved a purported revision of the terms of AOL’s equity
11 interest in PurchasePro, and AOL and the Company fraudulently accounted for the transaction by
12 reporting \$27.5 million in advertising revenue;

13 (d) So-called “round-trip” deals with various companies such as Bertelsmann
14 AG, Veritas Software Corporation, WorldCom, Inc., Qwest Communications, Hughes
15 Electronics Corporation, Gateway, Inc., Homestore, Inc., PurchasePro.com, Inc., Sun
16 Microsystems, Inc., Monster.com and Oxygen Media Inc., with respect to which AOL or AOL
17 Time Warner improperly reported at least \$1.4 billion in advertising revenue during the relevant
18 period;

19 (e) So called “jackpotting” where AOL and the Company impermissibly
20 “squeezed” multiple on-line advertising banners purchased by the same customer onto the same
21 screen and did so repeatedly during a short period of time at the end of a reporting period in
22 order to record the revenue in that particular reporting period;

23 (f) Converting an arbitration award against MovieFone, Inc. and the
24 settlement of litigation with Ticketmaster into \$36.7 million of advertising revenue;

25 (g) Booking gross, rather than net, revenue for advertising which AOL and
26 AOL Time Warner sold on behalf of eBay as a broker and merely earned a commission;

27 (h) Improperly converting contract termination fees from failing internet
28 companies into advertising revenue;

1 (i) Improperly accounting for cross-platform advertising deals (advertising
2 services provided by more than one AOL Time Warner division), including the double-booking
3 of advertising revenue;

4 (j) Reporting materially overstated AOL advertising revenue in numerous
5 AOL and Company press releases and financial statements;

6 (k) Failing to disclose the true current and anticipated condition of AOL's
7 advertising revenue and business, both before and after the Merger;

8 (l) Failing to properly account for the vastly inflated goodwill associated with
9 the AOL and Time Warner Merger; and

10 (m) Falsely representing that AOL and AOL Time Warner's financial
11 statements were prepared in conformance with generally accepted accounting principles
12 ("GAAP") and fairly represented the financial operation of the companies, and that certain of
13 those financial statements were audited in compliance with generally accepted auditing standards
14 ("GAAS").

15 14. Defendants' illegal actions during the relevant period artificially propped up the
16 price of AOL and AOL Time Warner securities when they were purchased, exchanged or
17 otherwise acquired by CalPERS, causing CalPERS to lose hundreds of millions of dollars.
18 Moreover, CalPERS also held on to shares that it otherwise may have sold had the truth been
19 disclosed.

20 15. On the other hand, Individual Defendants reaped billions of dollars in proceeds
21 selling their own AOL and AOL Time Warner securities at artificially inflated prices. A large
22 portion of the insider selling by Defendants was conducted during a four-month period just after
23 consummation of the Merger, during which time the Company was engaged in a \$5 billion
24 repurchase of its own stock, serving to further inflate the price of the stock. These insider sales
25 were made pursuant to "Stock Option Registration Statements" (defined herein at ¶ 362) which
26 contained materially false and misleading statements and omissions.

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17. This action is not removable to federal court. Section 22 of the 1933 Act states that “[e]xcept as provided in section 16(c), no case arising under this title and brought in any State court of competent jurisdiction shall be removed to any court in the United States.” Moreover, there is not complete diversity of citizenship, as Plaintiff and several of the Defendants are headquartered in or citizens of California.

19. The amount of damages sued for is in excess of the jurisdictional minimum of this court.

20. Plaintiff CalPERS purchased the publicly traded securities of AOL Time Warner in connection with and after the AOL Time Warner Merger and has been damaged thereby. CalPERS provides retirement and health benefit services to more than 1.3 million members and nearly 2,500 employers including active, inactive and retired members from the State, school districts and local public agencies. As of April 30, 2003, CalPERS had \$137.8 billion of assets under management.

21. Defendant AOL Time Warner is a Delaware corporation with its headquarters in New York, New York. The Company was formed in connection with the Merger of AOL and Time Warner, Inc. As a result of the Merger, AOL and Time Warner each became wholly owned

1 subsidiaries of AOL Time Warner. AOL Time Warner is named as a Defendant in its own right
2 for all liabilities of AOL Time Warner arising in conjunction with or after the Merger and for all
3 liabilities of AOL and Time Warner arising in conjunction or after the Merger. AOL Time
4 Warner is also named as a successor-in-interest for all liabilities of AOL and Time Warner
5 arising prior to or in conjunction with the Merger.

6 22. Defendant AOL is a Delaware corporation with its principal place of business in
7 Dulles, Virginia. It is a wholly owned subsidiary of AOL Time Warner. The AOL business,
8 based both before and after the Merger in Dulles, Virginia, consists principally of interactive
9 services, web properties, internet technologies and electronic commerce services. AOL is
10 responsible for its liabilities resulting from this lawsuit, whether arising before, in conjunction
11 with, or after the Merger.

12 23. Defendant Time Warner is a Delaware corporation with its headquarters in New
13 York, New York. Time Warner is a wholly owned subsidiary of AOL Time Warner. Time
14 Warner's principal business is to create and distribute branded information and entertainment
15 throughout the world. Time Warner is responsible for its liabilities resulting from this lawsuit,
16 whether arising before, in conjunction with, or after the Merger.

17 **The Individual Defendants:**

18 24. The following Defendants were Officers and/or Directors of AOL prior to the
19 Merger with Time Warner:

20 (a) Stephen M. Case. Defendant Stephen M. Case ("Case") co-founded AOL
21 in 1985 and served as its Executive Vice President from September 1987 to January 1991 and
22 Vice President of Marketing from 1985 to September 1987. He became a Director of AOL when
23 it first became a public company in September 1992, Chief Executive Officer in April 1993 and
24 Chairman of the Board in October 1995, holding all of these positions until the Merger was
25 consummated on January 11, 2001. Case was a signatory to the Joint Proxy Statement-
26 Prospectus incorporated into the Merger Registration Statement, the Stock Option Registration
27 Statements and the Bond Registration Statement (as defined herein at ¶ 311). Upon the Merger,
28

1 Case became an Affiliated Director and Chairman of the Board of AOL Time Warner. On
2 January 12, 2003, Case announced his resignation from the Company effective May 2003.

3 (b) Robert W. Pittman. Before joining AOL, from 1990 to September 1995,
4 Defendant Robert W. Pittman ("Pittman"), was President and Chief Executive Officer of Time
5 Warner Enterprises, a division of Time Warner Entertainment Company. Pittman moved to AOL
6 in November 1996, where he was President and Chief Executive Officer of AOL Networks, a
7 division of AOL, until February 1998. From February 1998 until the Merger, Pittman was
8 President and Chief Operating Officer of AOL. He was a Director of AOL from 1995 until the
9 Merger. Pittman was a signatory to the Joint Proxy Statement-Prospectus incorporated into the
10 Merger Registration Statement, the Stock Option Registration Statements and the Bond
11 Registration Statement. Upon the Merger, January 11, 2001, Pittman became Co-Chief
12 Operating Officer of AOL Time Warner and an Affiliated Director of the AOL Time Warner
13 Board of Directors. On April 19, 2001, Pittman also resumed his previous responsibilities for
14 operations of the AOL subsidiary of AOL Time Warner. In May 2002, Pittman became the sole
15 Chief Operating Officer of AOL Time Warner. On July 18, 2002, the day *The Washington Post*
16 reported on various accounting improprieties regarding AOL advertising revenue, Pittman
17 abruptly resigned.

18 (c) J. Michael Kelly. From June 1998 until the Merger, Defendant J. Michael
19 Kelly ("Kelly") was Senior Vice President, Chief Financial Officer and Assistant Secretary of
20 AOL. Kelly was a signatory to the Merger Registration Statement, Bond Registration Statement
21 and the Stock Option Registration Statements. Upon the Merger, Kelly became Chief Financial
22 Officer and Executive Vice President of AOL Time Warner. On or about November 1, 2001,
23 Kelly was appointed Chief Operating Officer of the AOL subsidiary of AOL Time Warner.

24 (d) David M. Colburn. From 1995 until the Merger, Defendant David M.
25 Colburn ("Colburn") was Senior Vice President of Business Affairs for AOL, who reported
26 directly to Defendant Pittman. Following the Merger, Colburn became Executive Vice President
27 and President of Business Affairs and Development for AOL Time Warner and continued to
28 report directly to Pittman. Colburn was AOL's, and then AOL Time Warner's chief deal-maker.

1 Colburn was terminated in August 2002 after he was identified as a subject of the SEC and DOJ
2 investigations.

3 (e) Eric Keller. Defendant Eric Keller (“Keller”) was Senior Executive Vice
4 President of Business Affairs and Development under, and reported directly to, Defendant
5 Colburn at AOL. After the Merger, Keller remained Senior Executive Vice President of Business
6 Affairs and Development and continued to work under, and report directly to, Defendant
7 Colburn. Keller was the number two deal-maker at AOL and AOL Time Warner. Various media
8 reports have identified Keller as a subject of the SEC and DOJ investigations.

9 (f) Joseph A. Ripp. Defendant Joseph A. Ripp (“Ripp”) was Executive Vice
10 President, Chief Financial Officer and Treasurer of Time Inc. until 1999. He then became the
11 Executive Vice President and Chief Financial Officer of Time Warner from 1999 until the
12 Merger. On October 16, 2000, Ripp was named Executive Vice President, Chief Financial
13 Officer and Treasurer of AOL subsidiary, effective upon the Merger. In September 2002, Ripp
14 became Vice Chairman of AOL, a position he currently maintains.

15 (g) Myer Berlow. Defendant Myer Berlow (“Berlow”) was Vice President for
16 National Accounts at AOL. Subsequently, he became President of AOL’s Worldwide Interactive
17 Marketing Division in the Business Affairs Department. Following the Merger, in August 2001
18 he became President of the Global Marketing Solutions Group. In September 2002, Berlow
19 became a Senior Advisor to the Company.

20 (h) Barry Schuler. Defendant Barry Schuler (“Schuler”) was President of
21 AOL Interactive Services from 1998 until the Merger. Upon the Merger, Schuler became
22 Chairman and Chief Executive Officer of AOL. Schuler was a signatory to the Bond
23 Registration Statement.

24 (i) Steven Rinder. Defendant Steven Rinder (“Rinder”) was Senior Vice
25 President of Business Affairs and Development in 2001 for the Company.

26 (j) Kenneth J. Novack. Defendant Kenneth J. Novack (“Novack”) was Vice
27 Chairman of AOL from May 1998 until the Merger. He was a Director of AOL from January
28 2000 until the Merger. Upon the Merger, Novack was appointed an Affiliated Director of the

1 Company and became its Vice Chairman. Novack was a signatory to the Merger Registration
2 Statement, Bond Registration Statement, and Stock Option Registration Statements.

3 25. Defendants Case, Kelly, Pittman, Colburn, Keller, Ripp, Berlow, Schuler, Rinder
4 and Novack are sometimes collectively referred to herein as the “AOL Individual Defendants.”

5 26. The following Defendants were Officers and/or Directors of Time Warner prior to
6 the Merger with AOL:

7 (a) Gerald M. Levin. From 1983 until January 1987 and from 1988 until the
8 Merger, Defendant Gerald M. Levin (“Levin”) was a Director of Time Warner. From January
9 1993 until the Merger, Levin was Chairman and Chief Executive Officer of Time Warner. He
10 served in multiple executive positions with Time Warner prior to 1993. Upon the Company’s
11 incorporation in February 2000, Levin was appointed Chief Executive Officer of AOL Time
12 Warner. Levin also became an Affiliated Director of AOL Time Warner’s Board of Directors.
13 Levin was a signatory to the Joint Proxy Statement-Prospectus incorporated into the Merger
14 Registration Statement, the Bond Registration Statement, and the Stock Option Registration
15 Statements. Levin retired from the Company in May 2002.

16 (b) Richard D. Parsons. Defendant Richard D. Parsons (“Parsons”) was a
17 Director of Time Warner from 1991 until the Merger. From February 1995 until the Merger,
18 Parsons was the President of Time Warner. Upon the Merger, Parsons became Co-Chief
19 Operating Officer at AOL Time Warner (along with Defendant Pittman). Parsons also became an
20 Affiliated Director of AOL Time Warner’s Board of Directors. Parsons was a signatory to the
21 Merger Registration Statement, the Bond Registration Statement, and the Stock Option
22 Registration Statements. Parsons became Chief Executive Officer of AOL Time Warner in May
23 2002, leaving his post as the Company’s Co-Chief Operating Officer. He is Chairman-Elect of
24 the AOL Time Warner Board of Directors.

25 (c) Wayne H. Pace. From July 1993 to March 2001, Defendant Wayne H.
26 Pace (“Pace”) held multiple executive positions with Time Warner, including that of Chief
27 Financial Officer. Following the Merger, in March 2001, Pace became Vice Chairman and Chief
28 Financial and Administrative Officer of Turner Broadcasting System, Inc. In November 2001,

1 Pace became the Company's principal financial officer as the Executive Vice President and
2 Chief Financial Officer of the Company. Pace was a signatory to the Bond Registration
3 Statement.

4 27. Defendants Case, Kelly, Pittman, Colburn, Keller, Ripp, Berlow, Schuler, Rinder,
5 Novack, Levin, Parsons and Pace, are sometimes collectively referred to herein as the
6 "Individual Defendants."

7 28. The following are additional Individual Defendants:

8 (a) Paul T. Cappuccio. Defendant Paul T. Cappuccio ("Cappuccio") was
9 Senior Vice President and General Counsel of AOL from August 1999 until the Merger. Upon
10 the Merger, Cappuccio became Executive Vice President, General Counsel and Secretary of the
11 Company. Cappuccio was a signatory to the Merger Registration Statement and the Bond
12 Registration Statement.

13 (b) Miles R. Gilburne. Defendant Miles R. Gilburne ("Gilburne") was AOL's
14 "chief corporate strategist" as Senior Vice President of Corporate Development for AOL from
15 February 1995 until December 1999. As Defendant Colburn's mentor, Gilburne was
16 instrumental in bringing Colburn to AOL. He was a Director of AOL from October 1999 until
17 the Merger. Upon the Merger, Gilburne became Director of AOL Time Warner. Gilburne was a
18 signatory to the Merger Registration Statement, Bond Registration Statement and the Stock
19 Option Registration Statements.

20 (c) James W. Barge. From March 1995 until the Merger, Defendant James W.
21 Barge ("Barge") was Assistant Controller for Time Warner. Following the Merger, Barge
22 became the Company's "principal accounting officer" as the Senior Vice President and
23 Controller for AOL Time Warner. Prior to joining Time Warner, Barge was with Ernst & Young
24 as a regional and national partner. Barge was a signatory to the Bond Registration Statement.

25 (d) Daniel F. Akerson. Defendant Daniel F. Akerson ("Akerson") was a
26 Director of AOL from 1997 until the Merger and a member of the AOL Audit Committee in
27 1998 and 1999. Following the Merger, Akerson became a Director of AOL Time Warner as well
28 as a member of the Company's Audit and Finance Committee. Akerson was a signatory to the

1 Merger Registration Statement, Bond Registration Statement and Stock Option Registration
2 Statements.

3 (e) Stephen F. Bollenbach. From 1997 until the Merger, Defendant Stephen F.
4 Bollenbach (“Bollenbach”) was a Director of AOL. Following the Merger, Bollenbach became a
5 Director of AOL Time Warner and the Chair of the Audit and Finance Committee. Bollenbach
6 was a signatory to the Merger Registration Statement, Bond Registration Statement, and Stock
7 Option Registration Statements.

8 (f) Frank J. Caufield. Defendant Frank J. Caufield (“Caufield”) was a
9 Director of AOL from 1991 until the Merger. He was a member and former Chair of the AOL
10 Audit Committee. Following the Merger, Caufield became a Director of AOL Time Warner.
11 Caufield was a signatory to the Merger Registration Statement, Bond Registration Statement and
12 the Stock Option Registration Statements.

13 (g) Franklin D. Raines. Defendant Franklin D. Raines (“Raines”) was a
14 Director of AOL and a member of the AOL Audit Committee from September 1998 until the
15 Merger. Following the Merger, Raines became a Director of AOL Time Warner and a member
16 of the Audit and Finance Committee. Raines was a signatory to the Merger Registration
17 Statement, Bond Registration Statement, and the Stock Option Registration Statements.

18 (h) R.E. “Ted” Turner. Defendant R.E. “Ted” Turner (“Turner”) was Vice
19 Chairman of Time Warner prior to the Merger and Vice Chairman of AOL Time Warner after
20 the Merger, until he resigned as Vice Chairman in early 2003. He signed the Merger Registration
21 Statement and the Stock Option Registration Statements.

22 (i) James L. Barksdale. Defendant James L. Barksdale (“Barksdale”) was a
23 director of AOL before the Merger and a director of AOL Time Warner after the Merger. He
24 signed the Merger Registration Statement and the Stock Option Registration Statements.

25 (j) Carla A. Hills. Defendant Carla A. Hills (“Hills”) was a director of Time
26 Warner before the Merger and a director of AOL Time Warner after the Merger. She signed the
27 Merger Registration Statement and the Stock Option Registration Statements.

1 (k) Reuben Mark. Defendant Reuben Mark (“Mark”) was a director of Time
2 Warner before the Merger and a director of AOL Time Warner after the Merger. He signed the
3 Merger Registration Statement and the Stock Option Registration Statements.

4 (l) Michael A. Miles. Defendant Michael A. Miles (“Miles”) was a director of
5 Time Warner before the Merger and a director of AOL Time Warner after the Merger. He signed
6 the Merger Registration Statement and the Stock Option Registration Statements.

7 (m) Francis T. Vincent, Jr. Defendant Francis T. Vincent, Jr. (“Vincent”) was
8 a director of Time Warner before the Merger and a director of AOL Time Warner after the
9 Merger. He signed the Merger Registration Statement and the Stock Option Registration
10 Statements.

11 (n) Raymond J. Oglethorpe. Defendant Raymond J. Oglethorpe
12 (“Oglethorpe”) was President of AOL’s Technologies unit, continuing in that position after the
13 Merger, until he was fired.

14 (o) Janice Brandt. Defendant Janice Brandt (“Brandt”) was President of
15 AOL’s Marketing unit, continuing in that position after the Merger, until she was fired.

16 (p) George Vradenburg, III. Defendant George Vradenburg, III
17 (“Vradenburg”) was Senior Vice President for Global and Strategic Policy of AOL prior to the
18 Merger and continued in this position with the AOL operation of AOL Time Warner after the
19 Merger, until he was fired.

20 (q) Kenneth B. Lerer. Defendant Kenneth B. Lerer (“Lerer”) was Senior Vice
21 President of AOL prior to the Merger and Executive Vice President with the AOL operation of
22 AOL Time Warner after the Merger, until he was fired.

23 (r) William J. Raduchel. Defendant William J. Raduchel (“Raduchel”) was
24 Senior Vice President and Chief Technology Officer of AOL prior to the Merger and Executive
25 Vice President with the AOL operation of AOL Time Warner after the Merger, until he was
26 fired.

(s) Mayo S. Stuntz, Jr. Defendant Mayo S. Stuntz, Jr. (“Stuntz”) was Chief Operating Officer of AOL’s Interactive Services Group prior to the Merger and Executive Vice President with the AOL operation of AOL Time Warner after the Merger, until he was fired.

Ernst & Young LLP

29. Defendant Ernst & Young is a firm of certified public accountants that maintains its headquarters in New York, New York and has offices in California. At all times relevant to this action, Ernst & Young provided auditing and accounting services to AOL and AOL Time Warner, including but not limited to, conducting audits of AOL and AOL Time Warner’s year-end financial statements and, beginning no later than the quarter ended March 31, 2000, reviewing AOL’s and the Company’s quarterly financial statements. In connection therewith, Ernst & Young issued unqualified audit reports related to AOL and AOL Time Warner’s financial statements, for the fiscal years 1999, 2000 and 2001. Ernst & Young also reviewed and approved the unaudited financial statements issued in connection with the Merger, including those in the Merger and Stock Option Registration Statements.

Underwriter Defendants

30. Defendant Morgan Stanley & Co. (“Morgan Stanley”) is a financial services institution, that, through its subsidiaries and divisions, provides commercial and investment banking services and advisory services. Its headquarters are located in New York, New York. Morgan Stanley acted as financial adviser to Time Warner in connection with the Merger and issued a false opinion that the Merger was fair to Time Warner and its shareholders. Morgan Stanley was a Joint Book-Running and Lead Manager for the April 2002 bond offering (the “Bond Offering”).

31. Defendant Salomon Smith Barney Inc. (“Salomon”) is currently a subsidiary of Citigroup, Inc., a financial services institution that, through its subsidiaries and divisions, provides commercial and investment banking services and commercial loans to corporate entities. Salomon’s headquarters are located in New York, New York. Salomon acted as financial advisor to AOL in connection with the Merger and helped to draft and circulate the

1 false and misleading Merger Registration Statement. Salomon was the Joint Lead Manager for
2 the 2002 Bond Offering.

3 32. Defendant Citigroup, Inc. (“Citigroup”), an international financial services
4 company, was formed in 1998 by the merger of Citigroup and Travelers Group. Citigroup, which
5 services more than 200 million customer accounts in more than 100 countries, is the corporate
6 parent and 100% owner of Defendant Salomon and reports Salomon’s financial results in its
7 consolidated financial statements. Through its corporate control over its subsidiary, Salomon,
8 Citigroup was able to control, and did control, Salomon during the relevant period.

9 33. Defendant Banc of America Securities LLC (“Banc of America”) is a subsidiary
10 of Banc of America Corp., a financial services institution that, through its subsidiaries and
11 divisions, provides commercial and investment banking services and commercial loans to
12 corporate entities, with principal offices in San Francisco, California, New York, New York and
13 Charlotte, North Carolina. Banc of America was a Joint Book-Running and Lead Manager of the
14 April 2002 Bond Offering.

15 34. Defendant J.P. Morgan Chase & Co. (“J.P. Morgan”) is a financial services
16 institution that, through its subsidiaries and divisions, provides commercial and investment
17 banking services and advisory services. J.P. Morgan whose, headquarters is in New York, New
18 York was a Joint Book-Running and Lead Manager of the April 2002 Bond Offering.

19 35. Defendants Morgan Stanley, Salomon, Citigroup, Banc of America and J.P.
20 Morgan are sometimes collectively referred to as the “Underwriter Defendants.”

21 **SUBSTANTIVE ALLEGATIONS**

22 **The Growth of AOL and Its Emphasis on Increasing Advertising Revenue**

23 36. In December 1996, in an effort to increase its subscriber numbers, AOL
24 introduced “flat-rate” subscription plans which permitted subscribers to spend unlimited amounts
25 of time online for a flat monthly fee. While this move did increase its members, its operating
26 margins went down and it faced intensifying competition from low-cost or free Internet access
27 providers. In an effort to boost its profits in other ways, the Individual Defendants, first at AOL,
28 and later at AOL Time Warner, devised various fraudulent schemes to artificially enhance

1 advertising revenue and, in turn, continue to generate substantial increases in the companies'
2 stock prices.

3 37. AOL's Form 10-K for the fiscal year ended June 30, 1997, described the
4 importance of advertising revenue to AOL's success:

5 An important component of the company's business strategy is to increase non-
6 subscription based revenues, including from advertising sales and transaction fees
7 associated with electronic commerce, and the sale of merchandise, which the
8 company believes are increasingly important to its growth and success. The
9 company continues to establish a wide variety of relationships with advertising
10 and electronic commerce partners in order to grow its non-subscription based
11 revenues and to provide AOL subscribers with access to a broad selection of
12 competitively priced, easy to order products and services.

13 38. Within AOL, and later AOL Time Warner, there was enormous pressure to show
14 increasing revenue each quarter and meet or exceed revenue targets. This was especially true
15 with respect to advertising revenue following AOL's shift in its business model to emphasize this
16 revenue source. A former AOL deal-maker in the October 30, 2000 *Industry Standard* article
17 entitled, "AOL's Rough Riders," confirmed that no matter how many advertising deals AOL was
18 generating, it was never enough: "Working there you were under pressure all of the time to make
19 your quota, especially at the end of the quarter." "Colburn would be screaming at people 'Why
20 the f -, aren't we hitting our numbers?'" Defendant Colburn was AOL's top deal-maker and chief
21 architect of many of the transactions making up AOL's fraudulent advertising revenue. The
22 "AOL Rough Riders" article further stated that, "Colburn is the driver when it comes to deals at
23 AOL.... He oversees all of the dealmaking the Company does."

24 39. The pressure to maintain continually impressive revenue growth and the need to
25 artificially inflate that revenue through the improper methods described herein, increased even
26 more as many of the internet companies that had given up enormous sums in dollars and equity
27 to partner with AOL (a significant source of AOL's advertising revenue) were achieving
28 disappointing results. Many overvalued internet companies which took advantage of the internet
bubble were seeing their stock prices drop well below their Initial Public Offering ("IPO")
prices. Other internet companies were seeing their stock prices fall precipitously not only

1 because of declining advertising revenue, but on concerns that a majority of Internet companies
2 would disappear altogether.

3 40. By at least August 2000, internal company documents showed that AOL was at
4 risk to lose substantial advertising revenue from existing customers the following fiscal year. In
5 September 2000, AOL documents estimated that AOL was at risk to lose \$108 million in
6 advertising revenue in the 2001 fiscal year (July 1, 2000-June 30, 2001) due to the financial
7 difficulties of its advertising customers. In early October 2000, Defendant Pittman and other
8 AOL executives were told that as a result of many failing dot-com customers of the Company,
9 AOL was at risk to lose \$140 million in advertising revenue the following calendar year.

10 **The Creation of AOL Time Warner and the Additional**
11 **Pressure to Report Growing Advertising Revenue**

12 41. AOL's need to demonstrate substantial and continuing revenue growth took on
13 even greater importance when AOL and Time Warner discussed merging the two companies.
14 The proposed Merger was jointly announced by AOL and Time Warner on January 10, 2000 and
15 termed by the media as "the deal of the century." The Individual Defendants had a substantial
16 personal interest in the Merger as they knew they would be permitted to accelerate the vesting of
17 their options upon consummation of the Merger and generate enormous sums of money for
18 themselves by converting the options into shares of stock and selling them on the open market.

19 42. On January 11, 2000, *The Los Angeles Times* reported that the deal came to
20 fruition when Time Warner was convinced that AOL's stock value was "real:"

21 Levin and Case said they had worked carefully to strike a reasonable compromise
22 on the values of their two companies.

23 "One of the creative breakthroughs was in the valuation," Case told The Times in
24 a joint interview with Levin. He said the key to coming to a final deal was Time
25 Warner's "recognition that these Internet values are real. . . ."

26 43. The value of AOL's stock for purposes of the Merger was based primarily on
27 AOL's reported advertising revenue and historical growth in that revenue source. Morgan
28 Stanley, for example, which advised AOL on the Merger, valued AOL's "advertising and
commerce" business at a multiple of between 44 and 171 of estimated revenue for fiscal year
2000, far greater than the multiples applied to the other segments of AOL's business.

1 44. The pressure to report impressive advertising revenue and growth became even
2 more intense after the Merger was announced. During the one year period between the Merger
3 agreement and the deal's consummation, the Individual Defendants were desperate to ensure that
4 the deal went through, despite the fact that the advertising market was weakening and the stock
5 prices of many dot-com companies were plummeting. Indeed, at least months before the Merger
6 was consummated, Individual Defendants were aware that AOL was at risk to lose substantial
7 amounts of advertising revenue in the current fiscal year and the next calendar year. As reported
8 in the July 18, 2002 issue of *The Washington Post*, James Pattie, who during the pendency of the
9 Merger was a Senior Manager in AOL's Business Affairs division, stated, "The bubble had
10 clearly burst, but senior management was under enormous pressure to hit the [financial] numbers
11 and close the Time Warner transaction, which would diversify the revenue base and lower the
12 risk profile of the Company."

13 45. On June 23, 2000, AOL and Time Warner announced that their respective
14 shareholders had voted to approve the Merger with AOL common shareholders to receive 1
15 share of AOL Time Warner common stock for each share of AOL they owned (then having a
16 market price of \$54.62 per share) and Time Warner common shareholders to receive 1.5 shares
17 of AOL Time Warner common stock for each share of Time Warner they owned (then having a
18 market price of \$79.50 per share). The Merger was finalized on January 11, 2001.

19 **Fraudulent Transactions And Improper**
20 **Accounting Used To Artificially Inflate AOL**
21 **And AOL Time Warner Advertising Revenue**

22 46. Both prior to and after the Merger, AOL and AOL Time Warner represented that
23 their financial statements were prepared in conformity with GAAP, the uniform rules,
24 conventions and procedures that define accepted accounting practice. However, during the same
25 period, AOL, the Company and the Individual AOL and AOL Time Warner Defendants,
26 materially overstated AOL's and AOL Time Warner's advertising revenue through sham
27 transactions and improper accounting as described below.

28 47. One of AOL and AOL Time Warner's more creative ways of inflating advertising
revenue was through the use of sham transactions and/or improper accounting in connection with

1 “round-trip,” “back to back” or “boomerang” deals. These deals involved, in some instances, the
2 participation of multiple parties in elaborate advertising revenue schemes relating to AOL’s
3 purchase of goods, services, equity or some combination thereof from another party with the
4 requirement of a reciprocal purchase of AOL’s advertising services. These circular “trades” or
5 “swaps,” as accounted for by AOL and AOL Time Warner, frequently gave the appearance that
6 AOL or AOL Time Warner had entered highly profitable multi-year, multi-million dollar deals
7 to sell advertising. Rather, AOL or the Company had really funneled, or “round-tripped,” the
8 entire value of the revenue it received from these sales directly back to the original customer
9 through simultaneous purchases of advertising, goods, services, or equity, resulting in no net
10 gain to AOL or AOL Time Warner.

11 48. Barter, a common practice of AOL and AOL Time Warner, was one mechanism
12 through which AOL conducted round-trip deals. Barter transactions were often used by AOL and
13 AOL Time Warner to lend an appearance of legitimacy to those transactions. As described
14 below, many of the improper transactions included aspects of both round tripping and barter.
15 However, barter deals involve an even greater ability to manipulate the amount of advertising
16 revenue ultimately reported. AOL and AOL Time Warner’s barter deals used to overstate
17 advertising revenue took at least three forms: (a) the exchange of advertising for a variety of
18 goods or services such as computers, telecommunication services and network devices; (b)
19 AOL’s equity investments in customers who used the funds to purchase advertisements; and (c)
20 the exchange of advertising known as “in kind” advertising.

21 49. Examples of AOL and AOL Time Warner round-trip and barter deals that were
22 improperly accounted for by AOL and AOL Time Warner include the following:

23 a. **Homestore, Inc.**

24 50. Sixteen separate sham transactions with Homestore, Inc. (“Homestore”) and AOL
25 and then AOL Time Warner occurred in the latter part of 2000 and the first half of 2001.
26 Although these Homestore deals are just some of the transactions devised by AOL or AOL Time
27 Warner to artificially inflate revenue, much is known about these deals because of an ongoing
28

1 criminal investigation into the Homestore matter that has already resulted in publicly disclosed
2 guilty pleas to criminal offenses by four Homestore executives.

3 51. The concept for the sham Homestore transactions was devised by Defendant
4 Keller, and approved by at least the person at AOL Time Warner to whom he directly reported,
5 Defendant Colburn. The sham deals were designed to work to the mutual benefit of Homestore
6 and AOL Time Warner so that they could both report bogus advertising revenue. As discussed
7 below, AOL Time Warner had a significant equity interest in Homestore, 3.9 million shares of
8 Homestore stock, and therefore the Company benefited from the sham deals when both it and
9 Homestore reported artificially inflated advertising revenue.

10 52. The Homestore deals involved “three legs.” In the first leg Homestore paid a
11 third-party for services and products that Homestore did not need, and for which it in fact,
12 overpaid. The second leg required the third parties to purchase advertising from AOL Time
13 Warner with most or all of the money Homestore paid to the third parties. Under the third leg,
14 AOL Time Warner purchased advertising from Homestore in the same amount that the third-
15 party paid to AOL Time Warner for advertising. Accordingly, AOL Time Warner and
16 Homestore secretly round tripped or purchased advertising revenue from themselves in sham
17 triangular transactions.

18 53. As part of these sixteen fraudulent transactions, in 2001 the third parties paid
19 AOL a total of \$45.1 million for advertising, with the agreement that AOL would funnel the
20 monies back to Homestore, after deducting an approximate \$9 million “commission.”

21 54. Homestore executives, and Defendants Keller and Colburn, agreed that the second
22 leg of the sham transactions would not be documented. The secret third parties included
23 PurchasePro, Inc., Investor Plus, FX Consultants, Classmates.com, Wizshop and Easy Roomates.

24 55. In June 2001, Defendant Keller was placed on administrative leave by AOL Time
25 Warner. After that, Defendant Ripp, then the Executive Vice President and Chief Financial
26 Officer of AOL, and Defendant Rinder, AOL’s Senior Vice President for Business Affairs and
27 Development, handled the sham deals for AOL.

1 56. The Company, and at least Defendants Ripp, Rinder, Colburn and Keller, were all
2 aware of the round-trip and fraudulent nature of the deals. Indeed, Defendants Keller and
3 Colburn concocted the scheme and Defendants Ripp and Rinder clearly knew of the details of
4 the deals, including where the money AOL Time Warner received was actually coming from and
5 that it was round-tripped back to Homestore. Defendants Ripp and Rinder, however, covered up
6 the sham deals to allow the Company to inflate advertising revenue and avoid adverse publicity
7 for both AOL Time Warner and Homestore, in which the Company had a significant equity
8 interest.

9 57. The fraudulent Homestore transactions have been confirmed by the guilty pleas to
10 criminal offenses of four Homestore executives in an ongoing DOJ investigation into the
11 Homestore matter. Although the criminal charges and guilty pleas do not identify AOL Time
12 Warner by name, they refer to the company that engaged in these transactions with Homestore as
13 a “major media company.” Furthermore, these documents describe the same three-legged
14 transactions referred to above and refer to the total of sixteen transactions and receipt by the
15 “major media company” of \$45.1 million in 2001 for advertising as part of these sham
16 transactions.

17 58. The Company improperly reported advertising revenue from these phony deals.
18 The transactions were shams agreed to with Homestore in order to report advertising revenue
19 that neither party “earned” as required by GAAP. Thus, even if the Company only reported its
20 bogus \$9 million “commission” as advertising revenue, and pro-rated it over the first two
21 quarters of 2001, the Company’s advertising revenue was overstated by \$4.5 million for each of
22 the quarters ended March 31, 2001 and June 30, 2001. Of course, if the Company reported the
23 entire \$45.1 million as advertising revenue, the overstated amount is even larger.

24 **b. Sun Microsystems, Inc.**

25 59. In a barter transaction with Sun Microsystems, Inc. (“Sun”), AOL overpaid for
26 goods at list price when normally it would receive a discount, thereby overstating the
27 consideration exchanged for AOL’s services in violation of APB 29. This transaction resulted in
28

1 approximately \$150 million of overstated advertising revenue over the course of the three year
2 deal.

3 60. The Sun transaction was announced on November 24, 1998 and involved the
4 swap of advertisements for computer equipment. A September 1, 2002 *New York Times* article
5 entitled, “Ouster at AOL, but Where Does Trail End?,” reported that AOL agreed to buy \$500
6 million in computer equipment from Sun at list price, even though companies like AOL typically
7 buy at a discount of more than 30 percent. For its part, Sun agreed to pay AOL \$350 million for
8 advertising services. A contemporaneous agreement provided for Sun to pay AOL more than
9 \$310 million per year as part of a three-year partnership called “iPlanet.” AOL treated these
10 payments from Sun as recurring revenue. Through this partnership, AOL was in effect receiving
11 back some of its own expenditures in order to artificially increase its own advertising revenue
12 and overstate income as a result. Furthermore, AOL and Sun would not have entered into the
13 transaction without the reciprocal purchases. Accordingly, under APB 29 revenue resulting from
14 the deal should have been reported net of the overpayment rather than on a gross basis.

15 61. At a minimum, AOL’s overpayment for Sun’s computer equipment, based on the
16 equipment’s fair market value, should have been recorded as a reduction of AOL’s advertising
17 revenue resulting from the round-trip transaction. Instead, AOL recorded the transaction based
18 on an inflated list purchase price for the computer equipment, resulting in at least a 30% or \$150
19 million, overstatement of advertising revenue. AOL therefore overstated its advertising revenue
20 by at least \$4.2 million for December 1998 and at least \$12.6 million per quarter starting with the
21 quarter ended March 31, 1999 through the quarter ended September 31, 2001 and \$8.4 million
22 for the quarter ended December 31, 2001. AOL’s relationship with Sun would serve as a
23 template for numerous other deals in which AOL bartered with other companies, round-tripping
24 money and reporting advertising revenue at greatly inflated values, in violation of GAAP.

25 **c. Veritas Software Corporation**

26 62. As pleaded in the Class Action Complaint, AOL also negotiated a deal in
27 September 2000 to pay \$50 million for \$30 million worth of software it purchased from Veritas
28

1 Software Corporation (“Veritas”) in a deal similar to the Sun transaction. AOL then overstated
2 its advertising revenue by \$20 million in violation of APB 29.

3 63. In a *Reuters* news release dated November 14, 2002, Veritas reported that, in
4 connection with the SEC’s investigation of AOL’s accounting, the SEC had subpoenaed Veritas’
5 records relating to transactions it entered into with AOL in September 2000.

6 64. On January 17, 2003, Veritas announced that, as a result of the SEC’s
7 investigation, it was restating its financial results for fiscal years 2000 and 2001, eliminating \$20
8 million in revenue previously booked as licensing and support fees paid by AOL. Further, the
9 Company announced that it would no longer record as an expense the \$20 million it paid AOL
10 for advertising.

11 65. Then, on or about March 17, 2003, Veritas disclosed in an amended Form 10-K
12 the restatement resulting from the AOL deal was based on a determination that the fair value of
13 the goods and services purchased and sold in the deal could not be “reasonably determined.” In
14 addition, Veritas disclosed that it was further restating its financials based on “two additional
15 contemporaneous transactions involving software licenses and the purchase of on-line
16 advertising services” to reflect additional reductions in revenue. Veritas’ auditor at the time of
17 these transactions, Defendant Ernst & Young, was replaced following the audit of the
18 Company’s year 2000 financial statements.

19 66. AOL’s and AOL Time Warner’s improper accounting for the Veritas deal
20 resulted in an overstatement of advertising revenue by at least \$4 million per quarter from the
21 quarter ended December 31, 2000 through the quarter ended December 31, 2001.

22 **d. Bertelsmann AG**

23 67. In a roundtrip transaction with Bertelsmann AG (“Bertelsmann”), AOL overstated
24 advertising revenue by nearly \$400 million when it bought out Bertelsmann’s interest in a joint
25 venture. Rather than take advantage of the discount being offered by Bertelsmann on the buy-out
26 price if paid in cash, AOL arranged to have Bertelsmann round-trip or rebate that portion of the
27 buy out price which would have constituted the discount amount back to AOL through the
28 purchase of advertising services. This transaction continued for two years and ultimately resulted

1 in AOL overstating advertising revenue by \$400 million over the course of the deal in violation
2 of APB 29.

3 68. In the first quarter of 1998, Bertelsmann paid AOL \$75 million for a 50% interest
4 in a joint venture to operate the CompuServe European online service. Each company invested
5 an additional \$25 million in this joint venture. In August 1999, AOL Europe introduced Netscape
6 Online in England and in May 2000, AOL Europe introduced CompuServe Office in Germany.

7 69. In March 2000, AOL and Bertelsmann announced plans to restructure their AOL
8 Europe joint venture and to undertake a new strategic alliance. The restructuring consisted of a
9 put and call arrangement for AOL to purchase, in two installments, Bertelsmann's 50% interest
10 in AOL Europe for consideration approximating \$6.7 billion.

11 70. According to a March 31, 2003 *Wall Street Journal* article, "A person familiar
12 with the situation said that when Bertelsmann initially asked AOL to be paid in cash for its AOL
13 Europe stake, it had offered a discount on the sale price in exchange. The person said AOL's
14 response was that it wasn't interested in a cash discount, but wanted a bigger ad deal.
15 Bertelsmann accounted for the advertising as a cost of the sale, the person said."

16 71. A March 29, 2003 *New York Times* article entitled "AOL Says SEC is
17 Challenging its Accounting" reported that "the agreement with Bertelsmann was negotiated at
18 the top levels of both companies" and also noted that, "current and former Bertelsmann
19 executives" had recently revealed that not only had they questioned the deal, but that they were
20 instructed by Bertelsmann's headquarters "to buy online advertising from AOL at inflated prices
21 to fulfill the purchase commitment made as part of the larger transaction."

22 72. Under GAAP (APB 29), AOL was obligated to report the deal at its fair market
23 value and any overpayment should have been recorded as a reduction of the revenue that was
24 recognized in connection with this deal. Since AOL would have received the discount, AOL
25 overstated its advertising revenue by \$16.3 million, \$65.5 million, \$39.8 million, \$0.5 million,
26 \$80.3 million and \$84.4 million per quarter, starting with the quarter ended March 31, 2001
27 through the quarter ended June 30, 2002, respectively. The fact that Bertelsmann recognized the
28

advertising purchase as a cost of the sale provides even further evidence that the Company improperly reported advertising revenue in connection with the Bertelsmann deal.

e. Gateway Inc.

73. In yet another round-trip transaction, AOL improperly accounted for the bundling of its internet services on Gateway Inc.'s ("Gateway") computers, thereby overstating advertising revenue by \$470 million in violation of the directives set forth in APB 29.

74. In or about late 1999 or early 2000, AOL and Gateway entered into an arrangement pursuant to which Gateway agreed to promote AOL's internet service to purchasers of its computers. Each time a Gateway computer purchaser subscribed to the AOL service, Gateway would receive a fee or "bounty" from AOL. According to an April 2, 2003 *Washington Post* article entitled "Gateway to Amend Financial Reports - SEC Had Raised Concerns Over AOL Deal," at the same time AOL paid a "bounty," Gateway in turn paid AOL for providing a free year of internet service on its computers.

75. Since there was no substance to the transaction other than swapping money, AOL should have reported the transaction at its zero value instead of improperly reporting the amounts as sales and corresponding costs of sales. As a result, AOL overstated its advertising revenue by \$340 million in 2000 and \$130 million in 2001 by recognizing the fees paid by Gateway as revenue.

76. On or about April 1, 2003, Gateway announced that it was restating previously reported revenue from its agreement with AOL in response to accounting concerns raised by the SEC, which had been investigating Gateway's accounting since at least November 2002.

77. AOL and AOL Time Warner's improper accounting for the Gateway internet deal resulted in an overstatement of advertising revenue, on a prorated basis, by at least \$85 million per quarter beginning with the quarter ended March 31, 2000 through the quarter ended December 31, 2000 and \$130 million for the quarter ended March 31, 2001.

f. WorldCom Inc.

78. Beginning in 1998, WorldCom Inc. ("WorldCom") and AOL entered into a "multi-year, multi-million dollar agreement" pursuant to which AOL paid at least \$900 million a

1 year to WorldCom to carry the bulk of its internet traffic, and AOL became WorldCom's largest
2 customer. In July 2001, WorldCom and AOL Time Warner struck a massive roundtrip/barter
3 deal in which WorldCom agreed to buy more than \$200 million in advertising across all AOL
4 Time Warner properties in exchange for AOL Time Warner continuing to keep its network
5 traffic on WorldCom's network. While not disclosed in the press releases announcing the deal,
6 AOL Time Warner also agreed to buy internet capacity from UUNet, a unit of WorldCom, to
7 expand AOL Time Warner's online network. The reciprocal transactions were used by AOL
8 Time Warner as a vehicle to improperly recognize advertising revenue of at least tens of millions
9 of dollars in violation of APB 29.

10 79. An August 22, 2002 *Wall Street Journal* article entitled, "Questionable AOL
11 Revenue Has WorldCom Link," noted the close relationship between the two companies
12 (Defendant Case held a seat on WorldCom's Board of Directors and AOL was WorldCom's
13 largest customer) and pointed out that, according to people familiar with the SEC's investigation
14 of AOL Time Warner, a substantial portion of the \$49 million of overstated advertising revenue
15 initially reported by the Company involved revenue inappropriately booked from the WorldCom
16 deal. In addition, the article stated that the deal was negotiated in part by Defendant Colburn.

17 80. In its Form 10-Q for the quarter ended June 30, 2002, AOL Time Warner revealed
18 that the initial reported overstatement amount of \$49 million impacted the quarter ended
19 December 31, 2000 through the quarter ended March 31, 2002. As a result, AOL Time Warner's
20 improper accounting for the WorldCom deal resulted in an overstatement of advertising revenue
21 by at least \$12.7 million for the quarter ended December 31, 2000, \$5.3 million for each of the
22 quarters ended March 31, June 30 and September 30, 2001, \$11.8 million for the quarter ended
23 December 31, 2001 and \$8.5 million for the quarter ended March 31, 2002.

24 **g. Qwest Communications**

25 81. In or about July 2001, AOL Time Warner entered into a reciprocal transaction
26 with Qwest Communications ("Qwest"). Under the deal, AOL reportedly agreed to use Qwest's
27 network and to purchase digital subscriber lines and network transport capacity. In return, Qwest
28 agreed to advertise in the Company's media properties including magazines, television

1 programming, and online services. In a related round-trip transaction, AOL agreed to buy
2 network capacity in Europe from KPNQwest, a Qwest affiliate, in return for which Qwest agreed
3 to purchase AOL advertising.

4 82. AOL Time Warner violated GAAP by failing to account for the transaction based
5 on the fair market value of the underlying instruments, either the network services or the
6 advertising services, whichever was more reasonably and readily determinable. Thus, the
7 reciprocal transactions were used by AOL as a vehicle to improperly recognize millions of
8 dollars of advertising revenue in violation of APB 29.

9 83. On August 23, 2002, *The New York Times* reported that another of the three deals
10 being examined by AOL Time Warner in connection with the Company's initial report of \$49
11 million in improperly reported revenue was the swap deal between the Company and Qwest.

12 **h. Hughes Electronics Corporation**

13 84. AOL improperly accounted for a June 21, 1999 round-trip/barter transaction
14 involving AOL's receipt of restricted stock in Hughes Electronics Corporation ("Hughes") in
15 exchange for advertising which allowed AOL and AOL Time Warner to overstate advertising
16 revenue. By overvaluing the stock received, AOL artificially inflated its advertising revenue by
17 nearly \$50 million per quarter over a 2-1/2 year period.

18 85. The June 1999 transaction expanded upon a preexisting partnership, entered into
19 on May 11, 1999, by the two companies to develop a combination set-top box that would make
20 DirecTV and AOL TV available to customers. Under the expanded alliance, AOL invested \$1.5
21 billion in General Motors ("GM") Series H 6.25% automatically Convertible Preferred Stock.
22 GM immediately invested the \$1.5 billion received from AOL in the stock of its subsidiary,
23 Hughes. In return, Hughes committed to increase its sales and marketing expenditures to AOL
24 over the next three years by approximately \$1.5 billion.

25 86. As included in its June 29, 1999 Form 8-K, a GM press release regarding the
26 AOL and Hughes deal stated that "the investment would be non-dilutive to earnings." Similarly,
27 a June 21, 1999 Internetnews.com article reported that "AOL said the investment will not have a
28 negative impact on its earnings." AOL made this statement because it knew the invested funds

1 were to be round-tripped back to AOL and accounted for by AOL as advertising revenue.
2 However, the bartered services (advertising revenue) were overstated in violation of GAAP,
3 particularly APB 29, SFAS 123 and EITF 00-08, since AOL did not properly value the barter
4 instrument (stock) exchanged for them. More specifically, while AOL entered into the round-
5 trip/barter deal under the guise of making an investment, the underlying instrument, not the
6 money to be exchanged, should have provided the basis for valuation.

7 87. Despite the amounts of money swapped (*i.e.*, \$1.5 billion from AOL for GM
8 Series H preferred stock in exchange for Hughes' commitment to purchase \$1.5 billion in
9 advertising from AOL), the underlying round-trip/barter deal was essentially an exchange of GM
10 Series H preferred stock for AOL advertising services. AOL's recognition of advertising revenue
11 at the full purported value of the stock violated GAAP. Since the stock was not publicly-traded
12 but was a class of stock created only for AOL and was not convertible until June 2002 (three
13 years later), the value of the stock at the time of the transaction was not \$1.5 billion, and thus the
14 associated AOL advertising services recorded based on that inflated amount over the period of
15 the deal was improper. Though the stock tracked Hughes' common stock (GM Series H common
16 stock), the stock's value three years in the future should, at a minimum, have had a time value
17 and marketability discount applied to it. As a result, applying conservative factors for time value
18 and a marketability discount, AOL's and AOL Time Warner's advertising revenue was
19 overstated by at least \$16 million for the quarter ended June 30, 1999, \$48 million per quarter
20 beginning in the quarter ended September 30, 1999 through the quarter ended March 31, 2000,
21 and \$32 million in the quarter ended June 30, 2000.

22 88. In its Form 10-K for the fiscal year ended December 31, 2001, filed on March 25,
23 2002, the Company reported a charge of "approximately \$270 million to reflect an other-than-
24 temporary decline in the carrying value of AOL Time Warner's investment in Hughes
25 Electronics Corp. ("Hughes"), an available-for-sale investment." On November 14, 2002, AOL
26 Time Warner acknowledged its material false statements relative to the value of its investment in
27 Hughes. In its Form 10-Q for the quarter ended September 30, 2002, the Company reported:
28

1 Included in the non-cash pretax charges for three and nine month periods ended
2 September 30, 2002 are charges related to the writedown of AOL Time Warner's
3 investment in Hughes Electronics Corp. ("Hughes") of \$505 million for both the
4 three and nine month periods.

5 **i. Homestore - The 2004 House and Home Deal**

6 89. In May 2000, AOL and Homestore entered into a five-year agreement whereby
7 AOL artificially inflated advertising revenue by approximately \$26.5 million per year by
8 improperly accounting for the value of stock it received in the deal. As part of the agreement,
9 Homestore became the exclusive distributor of home-buying and moving services across AOL
10 properties and AOL created the "House and Home" channel on its website. Homestore was the
11 exclusive content provider for the site. AOL and Homestore also agreed that they would share
12 revenue generated from the House and Home channel. In return, AOL received 3.9 million
13 shares of Homestore common stock, at a guaranteed value of \$68.50 per share, and \$20 million
14 in cash.

15 90. Just prior to the announcement of the AOL/Homestore agreement, Homestore's
16 stock price was \$18.25 a share, and immediately after the announcement it rose to \$22.875 a
17 share, a 25% increase.

18 91. As part of the deal, AOL also received a \$90 million letter of credit that
19 Homestore could draw upon up to a \$50 million cap if Homestore's stock price did not reach the
20 guaranteed price. This deal was orchestrated by Defendant Keller at AOL and Peter Tafeen at
21 Homestore, with Colburn having extensive involvement in the transaction.

22 92. Defendant Keller told Joseph Shew, a Homestore executive, in March or April
23 2000 that AOL's auditors had looked at the deal and that the \$20 million cash payment, the letter
24 of credit and certain termination provisions, were included in the agreement so that AOL could
25 recognize revenue. These provisions were not initially part of the agreement. Defendant Keller
26 told Shew that Defendant Colburn was directly involved in the negotiations of these terms.
27 Defendant Keller also told Shew that AOL would be recognizing \$50 million per year in revenue
28 from the agreement.

93. AOL reported the value of the deal to be \$287 million, or about \$57 million per year over the five-year term of the deal. AOL, however, failed to properly account for the consideration at its fair value, and thus violated APB 29, SFAS 123 and EITF 00-08, which would have included discounts for time value and marketability (transfer) restrictions. As a result, the Company improperly overstated advertising revenue by at least \$4.4 million for the quarter ended June 30, 2000 and \$6.6 million per quarter for the quarter ended September 30, 2000 through the quarter ended June 30, 2002.

j. Gateway Inc. Stock Purchase

94. AOL again improperly accounted for a round-trip/barter transaction involving the purchase of stock in a round-trip deal originally entered into with Gateway beginning on or about October 10, 1999. The stock was held only by AOL and unmarketable for three years.

95. According to the Class Action Complaint, the deal “was not arm’s length” and was misrepresented by AOL to the marketplace. AOL agreed to invest approximately \$800 million in Gateway, acquiring a 4.5% stake in the company in Gateway stock and warrants. In return, the agreement provided that Gateway would use the entire \$800 million it received from AOL for advertising and other strategic partnerships on AOL’s service. These Gateway investments included an online retail store joint venture of AOL and Gateway in which Gateway invested \$75 million. Both AOL and Gateway’s stock went up as a result of the publicity about this deal which was presented in press releases as being mutually beneficial to the companies. According to the Class Action Complaint, the deal was, in fact, a roundtrip/barter transaction in which AOL, through improper accounting, overstated advertising revenue.

96. The problem with the transaction is that AOL failed to use the underlying instrument (stock), as opposed to the money exchanged, as a basis for valuing the amount of advertising revenue to be recognized in the deal. As was its practice, in or about December, 2001, AOL invested \$200 million in a class of stock - 50,000 shares of non-voting Series A convertible preferred stock - that only AOL held. The Gateway stock was thus restricted and would not convert until 2002 and beyond (usually three years from the transaction date) depending on the trading prices on those dates. Consequently, proper valuation of the stock was

critical to AOL's recognition of advertising revenue in the Gateway deal. APB 29 required that a fair market value calculation be applied upon issuance of the stock and that the advertising revenue reported by AOL be discounted accordingly. AOL did not do so, thus violating APB 29, SFAS 123 and EITF 00-08, which required that the transaction be valued at the fair value of the instruments swapped, including time value and marketability discounts. By failing to properly value the Gateway stock, AOL and AOL Time Warner overstated advertising revenue by at least \$3 million in December, 2001 and \$9 million per quarter for the quarter ended March 31, 2002 through the quarter ended June 30, 2002.

k. Oxygen Media Inc. Stock Purchase

97. AOL Time Warner again improperly accounted for a round-trip/barter transaction involving the purchase of stock in a deal entered into with Oxygen Media Inc. ("Oxygen Media") in April, 2001. While not fully disclosed to the marketplace, AOL invested \$30 to \$50 million in Oxygen Media which operates a cable channel. As part of the deal, Oxygen Media's cable channel would be carried on the Company's cable systems and Oxygen Media would purchase \$100 million in advertising mostly from the AOL division of the Company.

98. On August 26, 2002, in an article entitled, "Officials Probe AOL's Actions With Partners," *The Wall Street Journal* reported on the Company's round-trip/barter deal with Oxygen Media:

For America Online, investing in companies that then advertised on the Internet service was about as crucial to its growth as taking in oxygen. Literally.

Last year, AOL invested \$30 million to \$50 million in Oxygen Media Inc. and arranged for the women-focused cable channel to be carried on parent AOL Time Warner Inc.'s cable systems. At the time, Oxygen agreed to buy about \$100 million in ads that mostly ran on America Online--a hefty amount for a start-up media company.

The Oxygen trades were one of the many complex deals that were a way of life at the America Online unit--and many other technology companies--during the boom years. At AOL, these deals sometimes included an investment. Other times, AOL squeezed its suppliers for advertising revenue. Either way, the deals weren't much of a secret--AOL was proud of its ingenuity in crafting the arrangements and expected AOL partner companies to buy ads on AOL. "If we're one of their big customers, we expect them to be one of our big customers," Robert Pittman, the since-departed chief operating officer, said in an interview last year.

1 99. The Oxygen Media carriage deal was unusual for not including a launch fee.
2 Networks like Oxygen Media routinely pay cable operators substantial launch fees to obtain
3 favorable channel positions on cable systems. Instead of paying the Company such a fee, which
4 could have been as much as \$100 million, Oxygen Media purchased advertising, principally
5 from the Company's AOL online division. To compensate Time Warner's cable division for not
6 receiving revenue from Oxygen Media in the form of a launch fee, the AOL online division
7 bought advertising on Time Warner cable. By failing to properly account for its round-trip deal
8 with Oxygen Media, AOL Time Warner overstated AOL advertising revenue by at least \$19.8
9 million per quarter for the five quarters ended June 30, 2001 through the quarter ended June 30,
10 2002.

11 **I. PurchasePro.com, Inc. Advertising Swap**

12 100. AOL and AOL Time Warner improperly accounted for an "in kind" advertising
13 deal with PurchasePro.com, Inc. ("PurchasePro"), which AOL used as a vehicle to improperly
14 inflate advertising revenue by at least \$13.9 million. PurchasePro was a start-up business-to-
15 business software firm. According to PurchasePro's Form 10-K for 2000 and its Form 10-Q for
16 the second quarter 2001, pursuant to the marketing agreement, PurchasePro bought advertising
17 space from AOL and, in two transactions, AOL purchased promotional subscriptions for use
18 with AOL customers for \$13.9 million. AOL's purchase of \$4.9 million (in 2000) and \$9 million
19 (in 2001) of PurchasePro's subscriptions for AOL's customers and PurchasePro's purchase of
20 advertising from AOL were round-tripped revenues.

21 101. Since AOL exchanged its advertising services for the PurchasePro subscriptions,
22 AOL should have recognized the advertising revenue in accordance with the requirements of
23 APB 29, which states that the fair market value of the instruments (subscriptions and advertising
24 services) should be used as the basis of the transaction. If unable to determine the fair market
25 value, the recorded amounts (costs) should be used to value the transaction (APB 29, ¶ 26),
26 which would be minimal to zero. AOL overstated its advertising revenue by at least \$4.9 million
27 for the quarter ended December 31, 2000 and \$9 million for the quarter ended June 30, 2001
28

1 because the fair value and cost of the PurchasePro subscriptions and AOL advertising was
2 virtually nothing.

3 **m. Monster.com**

4 102. AOL improperly accounted for another “in kind” advertising deal entered into
5 with Monster.com in late 1999, used by AOL to overstate advertising revenue by over \$29
6 million. The deal provided that AOL and Monster.com would promote each other by
7 exchanging advertisements.

8 103. Similar to the PurchasePro deal, because AOL exchanged or swapped its
9 advertising services for the Monster.com advertising, AOL should have recognized the
10 advertising revenue in accordance with the requirements set forth in APB 29 and EITF 99-17.
11 APB 29 states that the fair market value of the instruments (advertising services) should be used
12 as the basis of the transaction, which in this case would be zero. Further, applying the standards
13 set forth in SFAC 2, the transaction would be properly characterized as a sham and the substance
14 would be a net zero transaction despite its form. No “real” revenue was reportable. By failing to
15 comply with APB 29 and EITF 99-17, AOL and AOL Time Warner overstated advertising
16 revenue by at least \$2.08 million for the quarter ended December 31, 1999 and \$6.24 million for
17 each quarter beginning with the quarter ended March 31, 2000 through the quarter ended June
18 30, 2002.

19 **“Front Loading” or “Jackpotting” to Record Advertising Revenue**

20 104. Another category of deceptive advertising deals involved the practice of
21 manipulating the timing and placement of advertisements to report the revenue generated from
22 those advertisements in a particular quarter, thereby meeting internal goals or external earnings
23 estimates. This practice was referred to as “front loading” or jackpotting” and essentially meant
24 that AOL would flood its website at the end of each month and quarter.

25 105. A *Washington Post* article dated July 19, 2002 said that interviews with former
26 AOL employees revealed that the term “jackpotting” referred to gambling slot machines where,
27 for example, three cherries in a row wins. In AOL’s case, “jackpotting” meant it would run the
28

1 same ad three times on a single web page, often on the bottom of the screen, where it was less
2 visible.

3 **a. Catalina Marketing Corporation**

4 106. According to the Class Action Complaint, the Company engaged in “jackpotting”
5 as far back as 1998 in connection with Catalina Marketing Corporation (“Catalina”). Catalina
6 had signed a \$10 million dollar, two year contract to run supermarket advertising online with
7 AOL. Even though the food section of AOL was not ready to run the advertising, AOL
8 executives made sure the ads ran before the end of the quarter and in advance of the contractual
9 obligation so AOL could book the revenue.

10 107. The fact that AOL generated numerous advertisements in a short time frame,
11 allegedly many times on the same page (to the point that some customers complained of
12 excessiveness), to an earnings process does not alleviate the requirement of CON 5 ¶ 83 which
13 states, “Revenues are not recognized until earned. An entity’s revenue-earning activities involve
14 delivering or producing goods, rendering services, or other activities that constitute its ongoing
15 major or central operations, and revenues are considered to have been earned when the entity has
16 substantially accomplished what it must do to be entitled to the benefits represented by the
17 revenues.”

18 108. When AOL engaged in “jackpotting” in connection with, *inter alia*, Catalina
19 Marketing, it overstated advertising revenue by “squeezing” or “jackpotting” multiple
20 advertising impressions or banners, AOL did not perform under the contract. In other words,
21 when the ads began to run in such a fashion under this, and similar deals, there was no “earnings
22 process” taking place with regard to the superfluous or excessive advertisements because AOL
23 had not “substantially accomplished” the substance of the contract/agreements.

24 **b. Telefonica SA**

25 109. According to a July 19, 2002 article in *The Washington Post*, another example of
26 “jackpotting” occurred just prior to the Merger in connection with a Business Affairs deal to sell
27 \$15 million in online ads to Telefonica, SA, (“Telefonica”) a large Spanish telecommunications
28 company.

110. According to the July 19, 2002 *Washington Post* article, in order to book revenue from the Telefonica deal in the quarter ended December 31, 2000, AOL needed to run the advertising during that month and did so by placing the ads in high-traffic areas of AOL, such as its welcome screen, the first Web page people see when they use the service. The problem with the ads is that the link from AOL's English-language welcome screen took its users to a Spanish-language site, and Telefonica's computer servers couldn't handle all of the customer traffic from AOL.

111. Under GAAP, however, AOL did not substantially accomplish what it would be required to do in order to recognize revenue. As a result, AOL's advertising revenue was overstated by \$15 million for the quarters ended December 31, 2000 and March 31, 2001, respectively.

Converting Legal Disputes into Advertising Deals

112. Another impermissible accounting practice engaged in by AOL and AOL Time Warner involved the improper conversion of a legal dispute into an advertising deal. Specifically, AOL demanded that its litigation opponent purchase advertising in settlement of a dispute. This revenue was then improperly reported as advertising revenue.

a. 24dogs.com Arbitration Award

113. MovieFone Inc. ("MovieFone"), an online ticketing firm, won an arbitration award against a Wembley PLC subsidiary in 1998. When AOL purchased MovieFone in 1999, it turned the \$22.8 million arbitration award, plus interest, into online advertising revenue, recognized in AOL's fiscal quarter ended September 30, 2000. In return, AOL agreed that this purchase of advertising would satisfy the prior arbitration award. In a deal reached just days before the end of the quarter ended September 30, 2000, when AOL knew it was short of its targets for advertising revenue, Wembley agreed to purchase \$23.8 million in advertising for its online greyhound racing website, 24dogs.com. The importance of meeting revenue targets was even more critical because the consummation of the Merger with Time Warner was only months away. Accordingly, AOL quickly put together advertisements and ran enough of them by "jackpotting" to book \$16.2 million of advertising revenue in the quarter ended September 30,

2000. Such “jackpotting” overstated advertising revenue because there was no “earnings process” taking place with regard to the superfluous or excessive advertisements because AOL had not “substantially accomplished” the substance of the Wembley deal.

114. Moreover, AOL further violated GAAP by improperly converting its arbitration award into advertising revenue. This is because the initial recording of income (such as the MovieFone arbitration award) initially gave rise to the receivable. APB 16 ¶ 87 and SFAS 141 ¶ 37 require that assets of an acquired company (MovieFone) be recorded on the opening balance sheet at the time of the acquisition. The subsequent collection of that receivable would therefore have no income statement impact. Here, the overall impact of AOL’s accounting manipulations was to overstate advertising revenue by \$16.2 million and \$7.5 million for the quarters ended September 30, 2000 and December 31, 2000, respectively.

b. Ticketmaster Legal Action

115. In the same fiscal quarter ended September 30, 2000, AOL improperly converted another pending litigation with Ticketmaster into \$13 million in advertising revenue. By settling its action against Ticketmaster in exchange for Ticketmaster buying advertising from AOL, a settlement payment was made and should have been recorded as other income, not advertising revenue. CON 6 ¶ 82, and CON 5 ¶ 83 require that income resulting from peripheral or incidental transactions be treated as gains rather than revenue because they do not arise from a company’s central operations. The impact of this accounting manipulation was to overstate advertising revenue by \$13 million for the quarter ended September 30, 2000.

Booking Sales on a Gross Rather Than Net Basis to Inflate Advertising Revenue

116. Another deceptive practice of AOL and AOL Time Warner was its misrepresentation to investors of the nature of its agency relationship with particular customers. With respect to certain deals, AOL Time Warner served as an advertising broker for a customer and then represented the gross amount of the advertising sale to be AOL’s and AOL Time Warner’s own revenue, rather than reporting only the percentage of revenue properly accruing to AOL and the Company as a commission from the sale in violation of EITF Issue No. 99-19

1 117. AOL and AOL Time Warner had an agreement with the internet auction
2 company, eBay, to sell advertisements on eBay's behalf in return for a commission. In the
3 process, the Company improperly booked the sale of eBay's ads as its own advertising revenue
4 even though the sales were made for eBay.

5 118. Under GAAP, AOL and AOL Time Warner should have only recorded the
6 commissions earned as the companies' revenue, not the gross revenue amounts. AOL and AOL
7 Time Warner therefore overstated advertising revenue by at least \$16.8 million for each quarter
8 beginning with the quarter ended September 30, 1999 through June 30, 2001 and \$12.75 million
9 for the quarter ended September 30, 2001.

10 **Counting Repricing of Equity Stock Rights as Advertising Revenue**

11 119. AOL and AOL Time Warner also fraudulently recognized advertising revenue
12 when they revised the terms of their respective equity investment in existing advertising
13 customers in violation of GAAP.

14 120. AOL improperly accounted for its marketing deal with PurchasePro by
15 recognizing advertising revenue with respect to stock rights AOL held in PurchasePro. Pursuant
16 to an agreement entered into in or about March, 2000, AOL agreed to distribute software for
17 PurchasePro and, in exchange, received tens of millions of dollars in performance warrants. The
18 warrants, which are similar to stock options, gave AOL the right to buy PurchasePro stock for
19 \$63.26 per share. PurchasePro subsequently accelerated the vesting schedule for three million of
20 the warrants and adjusted the exercise price down to 0.01 a share. Based upon the change in the
21 vesting schedule for and pricing of these 3 million PurchasePro warrants, the Company
22 improperly booked \$20.5 million as advertising revenue in the quarter ended December 31, 2000
23 and another \$7 million in the quarter ended March 2001.

24 121. When PurchasePro reduced the exercise price of the warrants from \$63.26 to
25 \$0.01, AOL was required to recognize the change in value as a gain, rather than as advertising
26 revenue. CON 6 ¶ 82 states that "gains are increases in equity (net assets) from peripheral or
27 incidental transactions of an entity and from all other transactions and other events and
28 circumstances affecting the entity except those that result from revenues or investments by

owners.” CON 6 ¶ 78 states that “revenues are inflows or other enhancements of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.” Since the adjustment in price was not attributable to additional services provided by AOL or achieved milestones previously set in an agreement, as provided for in EITF 00-8, the reduction in price has no correlation to performance. Thus, AOL and AOL Time Warner violated GAAP and overstated advertising revenue by at least \$20.5 million for the quarter ended December 31, 2000 and \$7 million for the quarter ended March 31, 2001.

Converting Contract Termination Fees into Advertising Revenue

122. Another category of false reporting of advertising revenue involved the renegotiation of certain long-term advertising contracts. This situation arose in cases where companies, especially internet companies, with long-term advertising agreements with AOL and AOL Time Warner were facing financial difficulties and were at risk of not fulfilling their contracts. Rather than taking these companies to court to enforce the contracts and risk attracting negative attention to the health of AOL’s advertising business, AOL renegotiated the deals and required the companies to pay a fee for shortening the deal. AOL then improperly treated that fee as advertising revenue.

123. As detailed in a July 18, 2002 *Washington Post* article:

In some instances, AOL said in its written response to the Post, it would renegotiate a struggling dot.coms ad deal to shorten the term of the contract. The dot.com would pay AOL a fee for breaking the deal early, and that fee would be incorporated into the new, shorter-term ad deal, effectively creating a balloon payment. AOL would count all of the revenue, including the fee for renegotiating a shorter-term deal, as ad revenue.

From July 2000 through March 2001, AOL said, it booked \$56 million from dot-com deals that were terminated or restructured, about 3% of its \$2.1 billion in overall ad and commerce revenue during that time. In each quarterly earnings report during the period, the terminated and restructured deals range from 1.5 to 4.4% of AOL’s advertising and commerce revenue.

(Emphasis added.)

124. One example of a termination fee improperly recorded as advertising revenue by AOL is the \$9.625 million termination fee paid by Dr.Koop.com (“Dr.Koop”) when it cancelled

1 its contract with AOL. Dr.Koop entered into an \$89 million four-year deal with AOL in July
2 1999. In April 2000 the deal failed, and according to Dr.Koop's 2000 Form 10-K, the original
3 agreement between Dr.Koop and AOL was amended. In exchange for 3.5 million shares of
4 Dr.Koop common stock, Dr.Koop was, in turn, relieved of any further cash payment obligations
5 to AOL and all existing warrants (vested and unvested) were cancelled. AOL and Dr.Koop
6 agreed to reduce carriage on AOL for a twelve-month period subject to the terms of the amended
7 agreement. The value of the shares given to AOL to terminate the deal was placed at
8 approximately \$9.6 million.

9 125. AOL and AOL Time Warner violated GAAP by improperly recording the fees
10 received to shorten or terminate these contracts, including the Dr.Koop deal, as advertising
11 revenue from ongoing operations, rather than gains. Consequently, AOL and AOL Time Warner
12 overstated advertising revenue by at least \$9.6 million by failing to properly treat contract
13 cancellation fees as gains. The improperly reported Dr.Koop advertising revenue was reported
14 for the quarter ended June 30, 2000.

15 **"Cross-Platform" Deals to Inflate Advertising Revenue**

16 126. Time Warner clients soon learned that the "cross-promotions" and "synergies"
17 once touted as an inherent benefit of the Merger resulted in new deals with Time Warner
18 divisions that now required the purchase by the customer of advertising from the AOL division
19 as well. After the Merger of AOL and Time Warner, the two companies used their combined
20 strength to increase AOL's online advertising revenue by pressuring Time Warner clients to
21 convert purchases of, *inter alia*, cable programming into purchases of online advertising. And, in
22 at least one instance, the same advertising revenue was booked at more than one division.

23 **a. The Golf Channel**

24 127. In June 2001, the Golf Channel agreed to pay AOL Time Warner \$200 million for
25 advertising over five years in order to have its programming shown on Time Warner Cable. After
26 hearing about this deal, the AOL division asked for a piece of the deal. According to the July 18,
27 2002 *Washington Post* article, Time Warner cable successfully pressured the Golf Channel into
28 spending about \$15 million of the \$200 million on online advertising with AOL. This amount

1 helped the online division to report increased advertising revenue for the quarter ended
2 September 30, 2001. According to *The Washington Post*, AOL sources acknowledged that the
3 Golf Channel had “few options:” “We told them where and when” the ads ran . . . “They didn’t
4 have a choice.” The \$15 million transferred from the \$200 million cable deal was not legitimate
5 AOL advertising revenue under SOP 97-2 ¶ 10, because there was no relative fair value in the
6 AOL advertising for the Golf Channel.

7 128. Because the Golf Channel would not have agreed to spend money on online
8 advertising in the absence of the requirement that it do so as part of a larger advertising
9 “package,” AOL Time Warner overstated AOL’s advertising revenue by \$15 million for the
10 quarter ended September 30, 2001.

11 **b. Oxygen Media - Carriage Deal**

12 129. In a *Wall Street Journal* article dated October 24, 2002, it was disclosed that
13 certain of the Company’s improper transactions involved divisions other than the AOL online
14 unit. One of the deals identified in the article was AOL’s deal with Oxygen Media and the report
15 of “double booking” the same revenue at more than one Company division. According to the
16 article:

17 Oxygen’s deal called for Time Warner’s cable systems to agree to carry the
18 channel, and instead of paying a fee for this carriage, Oxygen spent about \$100
19 million in advertising on AOL properties, mostly on the online service. People
20 familiar with the situation say AOL engineered intercompany ad transactions so
21 that the revenue was effectively reflected in the divisional numbers of both the
22 online and cable units.

23 130. In the course of employing cross-platform marketing to generate advertising
24 revenue for the Company, AOL Time Warner overstated advertising revenue for its online
25 division by including revenue from other media platforms. In addition, the Company, “double-
26 booked” revenue received from Oxygen Media in more than one business segment, *i.e.*, it
27 recorded the same revenue in two sets of books beginning in the quarter ended June 30, 2001
28 through the quarter ended June 30, 2002 (the time period during which the advertising ran).

131. In addition, like the Golf Channel, Oxygen Media would not have agreed to spend
the \$100 million on advertising in the absence of the cable carriage agreement. As described

1 above, Oxygen's carriage deal was unusual for not including a launch fee, even though cable
2 networks routinely pay significant launch fees to obtain favorable channel positions. Instead of
3 paying the Company such a fee, which could have been as much as \$100 million, Oxygen Media
4 purchased advertising, principally from the Company's AOL online division. To compensate
5 Time Warner's cable division for not receiving revenue from Oxygen Media in the form of a
6 launch fee, the AOL online division bought advertising on Time Warner cable.

7 132. For AOL, the \$100 million commitment represented 3.4% of AOL's advertising
8 over the five quarters the deal ran - second quarter of 2001 through second quarter of 2002. For
9 Oxygen Media, the deal came just four months after the Company had cut the number of web
10 sites it operated from more than a dozen to four. Following announcement of the deal, Oxygen
11 Media reduced its web presence even further, to just two sites and eventually acknowledged that
12 "The deal was less lucrative than originally anticipated." As reported in an August 26, 2002 *Wall*
13 *Street Journal* article discussing the deal, when asked whether Oxygen media would have bought
14 advertising if it was not seeking carriage, the company's chief operation officer stated it was a
15 three-way deal and "I wouldn't separate" any of the elements. As stated above, Oxygen Media
16 would not have agreed to spend the \$100 million on online advertising in the absence of the
17 carriage deal being an inseparable part of the "package." Accordingly, AOL Time Warner
18 overstated advertising revenue by at least \$19.8 million per quarter over the five quarters
19 beginning with the quarter ended June 30, 2001 through the quarter ended June 30, 2002.

20 **The Company's Admissions of Materially Overstated Advertising Revenue**

21 133. AOL Time Warner has admitted that it materially overstated its advertising
22 revenue. Indeed, the Company has restated its advertising and commerce revenue in the amount
23 of \$190 million for the eight consecutive quarters ended September 30, 2000 through June 30,
24 2002, with the restatement reducing AOL's advertising revenue by \$168 million. According to
25 the Company, the remaining overstated amount of \$22 million "represents a reduction in
26 revenues from certain transactions related to the AOL segment in which the advertising was
27 delivered by other AOL Time Warner segments."
28

134. According to the Company's Form 8-K filed on October 23, 2002, the restatement by quarter of AOL's advertising and commerce revenue is as follows:

<u>QUARTER</u>	<u>RESTATED</u>
Quarter Ended 9/30/00	(\$66 million)
Quarter Ended 12/31/00	(\$22 million)
Quarter Ended 3/31/01	(\$13 million)
Quarter Ended 6/30/01	(\$28 million)
Quarter Ended 9/30/01	(\$16 million)
Quarter Ended 12/31/01	(\$17 million)
Quarter Ended 3/31/02	(\$6 million)

135. In addition, at the same time the Company restated its financial results, it publicly stated:

As a result of the restatement announced on October 23, 2002 by AOL and AOL Time Warner Inc. (the "Company"), the Company's financial statements for the affected periods should no longer be relied upon, including the audited financial statements for 2000 and 2001 contained in the Company's annual report on Form 10-K for the year ended December 31, 2001.

136. Under GAAP, restatement of previously issued financial statements is the most serious step, reserved only for circumstances where no lesser remedy is available. Under APB 20, Accounting Changes, restatements are only permitted, and are required, to correct material accounting errors or irregularities that existed at the time the financial statements were prepared. By restating AOL and AOL Time Warner's financial statements, the Company admitted that each document publishing the original financial statements contained untrue statements and/or omissions, of material fact. Similarly, by restating, the Company also conceded that each of the press releases disseminated to the investing public and each of the annual and quarterly reports on Form 10-K and Form 10-Q that were filed with the SEC, contained untrue statements of material fact, and/or failed to disclose material facts.

1 137. On March 28, 2003, the Company reported that it may have to restate up to
2 another \$400 million in advertising revenue for the years 2001 and 2002, regarding transactions
3 with Bertelsmann AG. The Company also reported on March 28, 2003, that further restatement
4 of advertising revenue was “possible” due to the “range of other transactions” that were the
5 subjects of the continuing SEC and DOJ investigations.

6 **The Materially False and Misleading Statements and Omissions of**
7 **Material Fact Regarding Artificially Inflated Advertising Revenue**

8 138. The sham transactions and improper accounting practices of the Company and
9 AOL and the Individual Defendants, which Ernst & Young permitted, caused the financial
10 statements of AOL and the Company for various fiscal periods, the press releases related thereto,
11 and statements of Individual Defendants, to be materially false and misleading, and to omit
12 material facts.

13 139. These material misrepresentations and omissions had the desired effect of
14 manipulating stock market analysts to favorably comment on the companies and causing
15 investors to purchase or otherwise acquire AOL, and later AOL Time Warner, stock at
16 artificially inflated prices and/or to cause investors to hold their AOL Time Warner stock when
17 they otherwise may have sold.

18 a. **The Fiscal Quarter Ended December 31, 1998**

19 140. On January 27, 1999, the AOL Individual Defendants caused AOL to issue a
20 press release reporting its financial results for its fiscal quarter ended December 31, 1998, that
21 exceeded analyst’s projections of the company’s advertising and commerce revenue and beat
22 analysts’ earnings predictions by 3 cents per share. As reported in *Business Wire*, the Company
23 set “new records in total revenues, advertising, commerce and other revenues, net income and
24 membership growth.” Specifically, the Company reported total net income of \$88 million and
25 advertising, commerce and other revenues of \$181 million.

26 141. On January 27, 1999, the *Dow Jones News Service* reported that AOL declared a
27 two-for-one stock split.
28

1 142. On or about February 10, 1999, the AOL Individual Defendants caused AOL to
2 file its Form 10-Q for the company's fiscal quarter ended December 31, 1998. The Form 10-Q
3 was signed by Defendants Case and Kelly. It contained substantially the same financial
4 information as the January 27, 1999 press release, including \$126 million in advertising and
5 commerce revenue, an increase of 133% over the year ago quarter, and \$729 million in
6 advertising and commerce backlog, up from \$320 million in the year ago quarter. In addition, the
7 Form 10-Q assured investors that the Company's financials were prepared in accordance with
8 GAAP:

9 The accompanying unaudited condensed consolidated financial statements, which
10 include the accounts of America Online, Inc. (the "Company") and its wholly and
11 majority owned subsidiaries, have been prepared in accordance with generally
accepted accounting principles for interim financial information and with the
instructions to Form 10-Q and Article 10 of Regulation S-X.

12 143. In fact, AOL's reported advertising and commerce revenue for the quarter and six
13 months ended December 31, 1998 was overstated by at least \$4.2 million as a result of AOL's
14 improper accounting for the Sun deal, as discussed above. Further, AOL's representation to the
15 public in its press release and related Form 10-Q filing that its advertising revenue backlog as of
16 December 31, 1998 was \$729 million was false because, due to AOL's improper accounting for
17 the Sun deal, the actual backlog was overstated by at least \$147 million, or by at least 25%.
18 Moreover, without this overstatement of the advertising backlog, the backlog would have
19 decreased from the prior quarter.

20 **b. The Fiscal Quarter Ended March 31, 1999**

21 144. On February 25, 1999, *The Wall Street Journal* reported that AOL's advertising
22 and commerce revenue was more important to market analysts' views of the Company than its
23 earnings, because such revenue carries a substantially higher profit margin than the revenue from
24 members' subscription fees.

25 145. On April 27, 1999, the AOL Individual Defendants caused AOL to issue a press
26 release reporting its financial results for its fiscal quarter ended March 31, 1999. AOL announced
27 "record" advertising and commerce revenue of \$210 million for the quarter and advertising and
28 commerce backlog of \$1.3 billion.

1 146. On April 28, 1999, a *Dow Jones News Service* article reported that analysts were
2 extremely impressed by AOL's staggering reported growth in advertising revenue.

3 147. On or about May 7, 1999, the AOL Individual Defendants caused AOL to file its
4 Form 10-Q for the fiscal quarter ended March 31, 1999. The Form 10-Q contained substantially
5 the same financial information as the April 24, 1999 press release, including advertising and
6 commerce revenue of \$210 million, an increase of 119% from the year ago quarter, and \$1.3
7 billion in advertising and commerce backlog. The Form 10-Q also reported advertising and
8 commerce revenue for the nine months ended March 31, 1999 as \$530 million, an increase of
9 127% from the nine months ended March 31, 1998. In addition, the Form 10-Q assured investors
10 that the Company's financials were prepared in accordance with GAAP:

11 The accompanying unaudited condensed consolidated financial statements, which
12 include the accounts of America Online, Inc. (the "Company") and its wholly and
13 majority owned subsidiaries, have been prepared in accordance with generally
accepted accounting principles for interim financial information and with the
instructions to Form 10-Q and Article 10 of Regulation S-X.

14 148. In fact, AOL's reported advertising and commerce revenue for the quarter and the
15 nine-months ended March 31, 1999 was overstated by at least \$12.6 million and \$16.8 million,
16 respectively, as a result of AOL's improper accounting for the Sun deal, as discussed above.
17 Further, AOL's representation to the public in its press release and related Form 10-Q filing that
18 its advertising revenue backlog as of March 31, 1999 was \$1.3 billion was false because, due to
19 AOL's improper accounting for the Sun deal, the actual backlog was overstated by at least
20 \$134.4 million, or at least 12%.

21 c. **The Fiscal Quarter and Year Ended June 30, 1999**

22 149. On July 21, 1999, the AOL Individual Defendants caused AOL to issue a press
23 release announcing "record" financial results for its fiscal quarter and year ended June 30, 1999.
24 AOL reported earnings of 13 cents for the quarter, two cents higher than the analysts' consensus
25 estimate. AOL also reported \$233 million of advertising and commerce revenue for the quarter,
26 \$1 billion of advertising and commerce revenue for the fiscal year, and \$1.5 billion in advertising
27 and commerce backlog.

150. On July 21, 1999 a *Dow Jones News Service* article titled, “AOL’s Strong Advertising/E-Commerce Revs Boosts Results,” reported that AOL’s advertising and commerce revenue was its fastest growing revenue source and helped offset slowing subscriber revenue:

A sharp increase in advertising and electronic-commerce revenues helped America Online, Inc. (AOL) beat analysts' earnings expectations for its fourth quarter, even as its European subscriber growth slumped.

* * *

The Dulles, Va., company reported fourth-quarter revenues of \$1.38 billion, up 46% from \$943 million a year ago. The latest results included \$233 million in advertising and e-commerce revenue, up 6% from a year ago, a sharper rate of increase than the other categories of revenue, subscriptions and enterprise solutions.

151. On or about August 13, 1999, the AOL Individual Defendants caused AOL to file its Form 10-K for the Company's fiscal quarter and year ended June 30, 1999. The Form 10-K was signed by Defendants Case and Kelly. It contained substantially the same financial information as the July 21, 1999 press release, including \$1 billion in advertising, commerce and other revenue in the fiscal year, an 84% increase over the \$543 million in such revenue in fiscal 1998, and \$1.5 billion in advertising, commerce and other backlog. The Form 10-K also reported \$765 million in advertising and commerce revenue in fiscal 1999, an increase of 114% over fiscal 1998. The Form 10-K highlighted AOL's increasing dependence on advertising revenue and the reported astronomical growth in advertising and commerce backlog:

An important component of the Company's business strategy in its Interactive Online Services business is an increasing reliance on advertising, commerce and other revenues. These revenues include advertising and electronic commerce fees, the sale of merchandise, as well as other revenues.... The growth of advertising, commerce and other revenues is important to the Company's business objectives, as these revenues provide an important contribution to the Company operating results. Advertising revenues are expected to grow in importance as the Company continues to leverage its large, active and growing user base.... Affecting the growth in advertising, commerce and other revenues is the backlog balance as of June 30, 1999, 1998 and 1997 of \$1,519 million, \$511 million and \$180 million, respectively. During fiscal 2000, approximately \$680 million of revenue will be generated from the June 30, 1999 backlog.

(Emphasis added.)

152. In addition, the Form 10-K assured investors that the Company's financials were prepared in accordance with GAAP:

1 The management of America Online, Inc. is responsible for the integrity and
2 objectivity of the financial and operating information contained in this Annual
3 Report on Form 10-K, including the consolidated financial statements covered by
4 the Report of Independent Auditors. These statements were prepared in
conformity with generally accepted accounting principles and include amounts
that are based on the best estimates and judgments of management, which it
believes, are reasonable under the circumstances.

5 153. The Form 10-K also incorporated, with Defendant Ernst & Young's consent, the
6 July 21, 1999 report of Ernst & Young which assured investors that the financial statements were
7 audited in accordance with GAAS and were in compliance with GAAP:

8 We conducted our audits in accordance with generally accepted auditing
9 standards We believe that our audits provide a reasonable basis for our
opinion.

10 In our opinion, the financial statements referred to above present fairly, in all
11 material respects, the consolidated financial position of America Online, Inc. at
12 June 30, 1999 and 1998, and the consolidated results of its operations and its cash
flows for each of the three years in the period ended June 30, 1999, in conformity
with generally accepted accounting principles.

13 154. In fact, AOL's reported advertising and commerce revenue for the quarter and
14 year ended June 30, 1999 was overstated by at least \$28.6 million and \$45.4 million,
15 respectively. The overstatement of \$28.6 million for the quarter was due to AOL's improper
16 accounting for the Sun (\$12.6 million) and Hughes (\$16 million) deals, respectively, as discussed
17 above. The overstatement of at least \$45.4 million for the year ended June 30, 1999 was also due
18 to AOL's accounting improprieties in connection with the Sun (\$29.4 million) and Hughes (\$16
19 million) deals, respectively. Further, AOL's representation in its July 21, 1999 press release and
20 the related Form 10-K that its advertising revenue backlog as of June 30, 1999 was \$1.5 billion
21 was false because the actual backlog was overstated by at least \$686.8 million, or 84%, due to
22 the improper accounting of the Sun (\$121.8 million) and Hughes (\$565 million) deals.

23 **d. The Fiscal Quarter Ended September 30, 1999**

24 155. On October 20, 1999, the AOL Individual Defendants caused AOL to issue a
25 press release announcing financial results for the quarter ended September 30, 1999, which beat
26 analysts' expectations for advertising and commerce revenue. *Business Wire* reported that AOL
27 set "new records for consolidated revenues, advertising and commerce revenues, operating
28 income, and membership growth in the first quarter" with advertising, commerce, and other

1 revenues reaching \$350 million, or twice fiscal 1999's September quarter. It also reported
2 advertising and commerce backlog of \$2 billion.

3 156. Analysts commented very favorably on the company's financial results. For
4 example, on October 21, 1999, *PR Newswire* reported:

5 "Yesterday, AOL reported Q1:00 results ahead of consensus expectations,"
6 reported E*Offering analyst Andrea Williams. "In our opinion, America Online
7 continues to be the dominant force in interactive media today, with a compelling
8 product offering a large and loyal customer base, robust advertising, and
9 sponsorship demand. We believe that AOL remains the company best-positioned
10 for the long term on the Internet."

11 (Emphasis added.)

12 157. On October 28, 1999, *Business Wire* reported that AOL had again declared a two-
13 for-one split of its common stock.

14 158. On November 2, 1999, the AOL Individual Defendants caused AOL to file its
15 Form 10-Q for the fiscal quarter ended September 30, 1999. The Form 10-Q was signed by
16 Defendants Case and Kelly. It contained substantially the same financial information as the
17 October 20, 1999 press release, including advertising, commerce, and other revenue of \$350
18 million, an increase of 100% from the year ago quarter, and advertising and commerce backlog
19 of \$2 billion. It also reported advertising and commerce revenue of \$272 million for the quarter.
20 In addition, the Form 10-Q assured investors that AOL's financials were prepared in accordance
21 with GAAP:

22 The accompanying unaudited condensed consolidated financial statements, which
23 include the accounts of America Online, Inc. (the "Company") and its wholly and
24 majority owned subsidiaries, have been prepared in accordance with generally
25 accepted accounting principles for interim financial information and with the
26 instructions to Form 10-Q and Article 10 of Regulation S-X.

27 159. In fact, AOL's reported advertising and commerce revenue for the quarter ended
28 September 30, 1999 of \$272 million was overstated by at least \$77.4 million, an overstatement of
the actual advertising and commerce revenue by at least 40%, as a result of AOL's improper
accounting for the Sun (\$12.6 million), Hughes (\$48 million) and eBay (\$16.8 million) deals
discussed above. Further, AOL's representation to the public in its October 20, 1999 press
release and the related Form 10-Q that its advertising revenue backlog as of September 30, 1999

1 was \$2 billion was false because the actual backlog was overstated by at least \$726 million, or
2 57%, due to the improper. accounting of the Sun (\$109.2 million), Hughes (\$517 million), and
3 Monster.com (\$100 million) deals.

4 e. **The Fiscal Quarter Ended December 31, 1999**

5 160. On January 10, 2000, the Individual Defendants caused AOL and Time Warner to
6 issue a joint press release announcing that the board of directors of both companies had
7 unanimously approved a merger agreement to create a new company called AOL Time Warner.

8 161. On January 19, 2000, the AOL Individual Defendants caused AOL to issue a
9 press release announcing “record” financial results for the quarter ended December 31, 1999,
10 including record revenue of \$1.6 billion, 27% of which was advertising, commerce and other
11 revenue. According to the press release in *Business Wire*, second quarter revenues rose to \$1.6
12 billion, or 41% over last year’s second quarter, and advertising, commerce and other revenues
13 reached \$437 million, 79% over fiscal 1999’s December quarter. The press release further
14 announced that its consolidated backlog from advertising and commerce was more than \$2.4
15 billion at the end of the quarter.

16 162. On January 20, 2000, the AOL Individual Defendants caused AOL to file with the
17 SEC its Current Report on Form 8-K dated January 19, 2000 which was signed by Defendant
18 Kelly and incorporated AOL’s press release of January 19, 2000 announcing AOL’s financial
19 results for the quarter ended December 31, 1999.

20 163. On January 20, 2000, *The Wall Street Journal* praised AOL’s reported growth in
21 advertising revenue and stated that AOL executives had announced high earnings expectations
22 for the Company following the planned Merger with Time Warner.

23 164. On or about February 11, 2000, the AOL Individual Defendants caused AOL to
24 file with the SEC its Current Report on Form 8-K dated January 10, 2000 which was signed by
25 Defendant Kelly and incorporated AOL Time Warner’s pro forma consolidated condensed
26 financial statements for the three months ended September 30, 1999, the year ended June 30,
27 1999, the nine months ended September 30, 1999 and year ended December 31, 1998. The pro
28 forma consolidated condensed financial statements were materially false and misleading,

1 because they included AOL's fraudulently inflated advertising revenue reported for the
2 respective fiscal periods as discussed at ¶¶ 143, 154, 159.

3 165. On or about February 14, 2000, the AOL Individual Defendants caused AOL to
4 file its Form 10-Q for the fiscal quarter ended December 31, 1999. The Form 10-Q was signed
5 by Defendants Case and Kelly. It contained substantially the same financial information as the
6 January 19, 2000 press release, including advertising, commerce, and other revenue of \$437
7 million, an increase of 79% from the year ago quarter, and an advertising and commerce backlog
8 of \$2.4 billion. The Form 10-Q also stated that AOL had \$352 million in advertising and
9 commerce revenue for the quarter ended December 31, 1999, an 87% increase over the year ago
10 quarter, and commerce and advertising for the six month period ended December 31, 1999 of
11 \$624 million, an increase of 94% over the six months ended December 31, 1998. In addition, the
12 Form 10-Q assured investors that America Online's financials were prepared in accordance with
13 GAAP:

14 The accompanying unaudited condensed consolidated financial statements, which
15 include the accounts of America Online, Inc. (the "Company") and its wholly and
16 majority owned subsidiaries, have been prepared in accordance with accounting
17 principles generally accepted in the United States for interim financial
information and with the instructions to Form 10-Q and Article 10 of Regulation
S-X.

18 166. In fact, AOL's reported advertising and commerce revenue of \$352 million for
19 the quarter and \$624 million for the six-months ended December 31, 1999 was overstated by at
20 least \$79.5 million, and \$156.9 million, respectively, or in percentage terms, an overstatement of
21 the actual advertising and commerce revenue by at least 29% and 34%, respectively. AOL's
22 reported advertising, commerce and other revenue was similarly overstated by \$79.5 million and
23 \$156.9 million for the three and six-month periods, respectively. The overstatement of \$79.5
24 million during the quarter was due to AOL's improper accounting of the Sun (\$12.6 million),
25 Hughes (\$48 million), Monster.com (\$2.1 million) and eBay (\$16.8 million) deals, as discussed
26 above. In addition, the overstatement of at least \$156.9 million during the six-months ended
27 December 31, 1999 is attributable to AOL's improper accounting for the Sun (\$25.2 million),
28

1 Hughes (\$96 million), Monster.com (\$2.1 million) and eBay (\$33.6 million) deals, as discussed
2 above.

3 167. Further, AOL's representation to the public in its press release of January 19,
4 2000 and the related Form. 10-Q filing that its advertising revenue backlog as of December 31,
5 1999 was \$2.4 billion was false because the actual backlog was overstated by at least \$1.2
6 billion, or at least 101%, due to the improper accounting of the Sun (\$96.6 million), Hughes
7 (\$469 million), Monster.com (\$97.8 million), and Gateway (\$541.5 million) deals.

8 **f. The Fiscal Quarter Ended March 31, 2000**

9 168. On April 3, 2000, the AOL Individual Defendants caused AOL to file with the
10 SEC its Current Report on Form 8-K dated April 3, 2000, that incorporated AOL Time Warner
11 pro forma consolidated condensed financial statements for the six months ended December 31,
12 1999, the year ended June 30, 1999, and the year ended December 31, 1999. The pro forma
13 consolidated condensed financial statements were materially false and misleading, because they
14 included AOL's fraudulently inflated advertising revenue reported for the respective fiscal
15 periods, as discussed above.

16 169. On April 18, 2000, the AOL Individual Defendants caused AOL to issue a press
17 release, again announcing "record" financial results for the quarter ended March 31, 2000 and
18 soundly beating analyst predictions of advertising, commerce and other revenue by over \$100
19 million. As reported by *Business Wire*, AOL's third quarter revenues rose to \$1.8 billion, of
20 which \$557 million was from advertising, commerce and other revenues. The press release
21 further reported that AOL's consolidated backlog of advertising and commerce revenue was
22 more than \$2.7 billion at the end of the quarter, up from \$2.4 billion on December 31, 1999.

23 170. The press release was included in AOL's Current Report on Form 8-K dated April
24 18, 2000 and signed by Defendant Kelly that was filed with the SEC on April 21, 2000.

25 171. On April 18, 2000, in commenting upon AOL's just released financial results,
26 *Dow Jones News Service* quoted Defendant Kelly as stating, "[w]e saw across the board, and
27 across all brands, strong growth in advertising and e-commerce revenue."
28

172. On April 21, 2000, a *Dow Jones News Service* article, titled “Tech Week in Review” likewise reported AOL’s very strong advertising and commerce revenue growth. It also noted that a J.P. Morgan analyst warned investors to stay away from most internet stocks, but continued to rate AOL a top recommendation.

173. On or about May 15, 2000, the AOL Individual Defendants caused AOL to file its Form 10-Q for the fiscal quarter ended March 31, 2000. On May 17, 2000, the AOL Individual Defendants caused AOL to file a Form 10-Q/A for the period ended March 31, 2000. Both the Form 10-Q and 10-Q/A were signed by Defendants Case and Kelly. Both the Form 10-Q and Form 10-Q/A contained substantially the same financial information as the April 18, 2000 press release, including advertising, commerce and other revenue of \$557 million, a 103% increase from the year ago quarter, and \$2.7 billion in advertising and commerce backlog. The Form 10-Q and Form 10-Q/A also stated that AOL had \$463 million in advertising and commerce revenue, a 119% increase over the year ago quarter, and \$1,087 million in advertising and commerce revenue for the nine months ended March 31, 1999, a 104% increase over the nine months ended March 31, 1998. In addition, both the Form 10-Q and the Form 10-Q/A assured investors that AOL’s financials were prepared in accordance with GAAP:

The accompanying unaudited condensed consolidated financial statements, which include the accounts of America Online, Inc. (the “Company” or “America Online”) and its wholly and majority owned subsidiaries, have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X.

174. In fact, AOL’s reported advertising and commerce revenue of \$463 million for the quarter and \$1.1 billion for the nine-months ended March 31, 2000 was overstated by at least \$168.6 million, and \$325.5 million, respectively, or on a percentage basis, an overstatement of the actual advertising and commerce revenue by at least 57% and 43%, respectively, as a result of AOL’s improper accounting. The overstatement of \$168.6 million during the quarter was due to AOL’s improper accounting for the Sun (\$12.6 million), Hughes (\$48 million), Monster.com (\$6.2 million), Gateway (\$85 million) and eBay (\$16.8 million) deals, as discussed above. The overstatement of at least \$325.5 million during the nine months ended March 31, 2000 was due

1 to AOL's improper accounting for the Sun (\$37.8 million), Hughes (\$144 million), Monster.com
2 (\$8.3 million), Gateway (\$85 million) and eBay (\$50.4 million) deals, as discussed above.

3 175. Further, AOL's representation to the public in its press release dated April 18,
4 2000 and the related Forms 10-Q and 10-Q/A filings that its advertising revenue backlog as of
5 March 31, 2000 was \$2.7 billion was false. The actual backlog was overstated by at least \$1.1
6 billion, or at least 73%, due to the improper accounting of the Sun (\$84 million), Hughes (\$421
7 million), Monster.com (\$91.5 million), Gateway (\$456.6 million), DrKoop.com (\$9.6 million)
8 and Homestore.com (\$79.4 million) deals.

9 176. The Form 10-Q/A for the quarter ended March 31, 2000 also reiterated the
10 advertising and commerce revenue and advertising backlog previously reported for the year
11 ended June 30, 1999, again overstating AOL's financial results for the period as discussed above.

12
13 177. On February 11, 2000, the Company filed the Merger Registration Statement as
14 amended on March 24, 2000, April 25, 2000, May 18, 2000 and May 19, 2000, which contained
15 or incorporated by reference all items referenced in ¶¶ 290, 295-301 including the Merger
16 Agreement, historical AOL financial data, pro forma consolidated financial data of AOL Time
17 Warner, including AOL Time Warner's consolidated balance sheet as of March 31, 2000, the
18 Fairness Opinion of Morgan Stanley and Ernst & Young's unqualified audit reports as
19 referenced in ¶¶ 299-300, all of which were materially false and misleading for the reasons set
20 forth in ¶¶ 302-307.

21 178. Unaware of the concealed adverse information discussed herein, the shareholders
22 of AOL and AOL Time Warner voted to approve the Merger of the two companies on June 23,
23 2000.

24 **g. The Fiscal Quarter and Year Ended June 30, 2000**

25 179. On July 19, 2000, *Dow Jones News Service* reported that, based on AOL's prior
26 financial results, expectations for AOL's advertising and commerce revenue and earnings were
27 very high, notwithstanding the weakness in the internet advertising market and that "[b]uoyed by
28

1 strong advertising and electronic-commerce revenue, America Online, Inc. (AOL) is expected to
2 post fourth-quarter earnings ahead of the analysts' consensus estimate."

3 180. On July 20, 2000, the AOL Individual Defendants caused AOL to announce
4 record financial results for the quarter ended June 30, 2000, again surpassing analysts'
5 expectations for advertising, commerce and other revenue. The *Dow Jones News Service*
6 reported that the Company's fourth-quarter revenue from advertising and electronic commerce
7 jumped 95% from a year ago to 609 million, ahead of most analysts' estimates. AOL further
8 announced that its backlog of advertising revenues rose to \$3 billion. Defendant Pittman was
9 quoted by the *Dow Jones News Service* as saying "[w]e're getting, more advertising dollars than
10 anyone except the top four television networks."

11 181. On or about September 22, 2000, the AOL Individual Defendants caused the
12 Company to file its Form 10-K for the Company's fiscal quarter and year ended June 30, 2000.
13 On October 30, 2000, the AOL Individual Defendants caused AOL to file a Form 10-K/A for the
14 fiscal quarter ended June 30, 2000. Both the Form 10-K and Form 10-K/A were signed by, *inter*
15 *alia*, Defendants Case, Pittman and Kelly. Both the Forms 10-K and 10-K/A contained
16 substantially the same financial information as the July 20, 2000 press release, including
17 advertising, commerce, and other revenue of \$609 million for the quarter, and advertising and
18 commerce backlog of \$3 billion. Both the Forms 10-K and 10-K/A also stated that AOL had \$1.6
19 billion in advertising and commerce revenue in fiscal 2000, an increase of 107% over fiscal
20 1999, as well as \$1,986 million of advertising, commerce, and other revenue in fiscal 2000.

21 182. Both the Forms 10-K and 10-K/A also incorporated, with Defendant Ernst &
22 Young's consent, the July 20, 2000 report of Ernst & Young which assured investors that the
23 Company's financials were audited in accordance with GAAS and in compliance with GAAP:

24 We conducted our audit in accordance with auditing standards generally accepted
25 in the United States We believe that our audits provide a reasonable basis for
our opinion.

26 In our opinion, the financial statements referred to above present fairly, in all
27 material respects, the consolidated financial position of America Online, Inc. at
28 June 30, 2000 and 1999, and the consolidated results of its operations and its cash

1 flows for each of the three years in the period ended June 30, 2000, in conformity
2 with accounting principles generally accepted in the United States.

3 183. In fact, AOL's reported advertising and commerce revenue of \$513 million for
4 the quarter and \$1.6 billion for the year ended June 30, 2000 was overstated by at least \$166.7
5 million, and \$492.2 million, respectively, or in percentage terms, an overstatement of the actual
6 advertising and commerce revenue by at least 48% and 44%, respectively, as a result of AOL's
7 improper accounting. Likewise, AOL's advertising, commerce, and other revenue for the quarter
8 and year ended June 30, 2000 of \$609 million and \$1.986 billion, respectively, was overstated by
9 at least 38% and 33%, respectively. The overstatement of at least \$166.7 million for the quarter
10 was due to AOL's improper accounting of the Sun (\$12.6 million), Hughes (\$32 million),
11 Gateway (\$85 million), Homestore (\$4.4 million), DrKoop.com (\$9.6 million), Monster.com
12 (\$6.2 million) and eBay (\$16.8 million) deals, as discussed above. The overstatement of at least
13 \$492.2 million for the year ended June 30, 2000 was similarly due to AOL's improper
14 accounting of the Sun (\$50.4 million), Hughes (\$176 million), Gateway (\$170 million),
15 Homestore (\$4.4 million), DrKoop.com (\$9.6 million) Monster.com (\$14.6 million) and eBay
16 (\$67.2 million) deals.

17 184. Further, AOL's representation in its July 20, 2000 press release and its related
18 Form 10-K and Form 10-K/A filings that its advertising revenue backlog as of June 30, 2000 was
19 \$3 billion was false because the actual backlog was overstated by at least \$1 billion, or 52%, due
20 to the improper accounting of the Sun (\$71.4 million), Hughes (\$389 million), Monster.com
21 (\$85.3 million), Homestore.com (\$75 million), Gateway (\$371.7 million), Ticketmaster (\$13
22 million) and 24dogs.com (\$23.7 million) deals, as discussed previously.

23 185. Both the Form 10-K and 10-K/A incorporated by reference the Merger
24 Agreement between AOL and Time Warner, which contains false representation and warranties
25 by AOL, as discussed herein at ¶ 307.

26 **h. The Fiscal Quarter Ended September 30, 2000**

27 186. *The Washington Post* reported in its July 18, 2002, article that by at least August
28 2000, AOL executives, including Defendants Colburn and Berlow, knew that various advertising

1 customers of the Company were experiencing financial problems that jeopardized existing AOL
2 advertising agreements. Sometime in September 2000, internal AOL documents showed that
3 AOL was “at risk” to lose more than \$108 million in advertising revenue for the 2001 fiscal year
4 (July 2000 - 2001) due to the many failing dot-com companies. This estimate quickly increased
5 within the Company. Indeed, at the beginning of October 2000, Bob O’Connor, then AOL’s Vice
6 President of Finance for its advertising division, warned Defendant Pittman and several other
7 Company executives that AOL was at risk of losing \$140 million in advertising revenue in the
8 2001 calendar year because many internet companies which had advertising contracts with AOL
9 were failing. *The Washington Post* article also reported that AOL considered suing the failing
10 dot-com companies, but chose not to do so “because the public filings would show some
11 weakness in its business.”

12 187. On October 18, 2000, the AOL Individual Defendants caused AOL to issue a
13 press release announcing “Record-Breaking Results for FY2001 First Quarter... Advertising,
14 Commerce and Other Revenues Jump 80% to \$649 Million.” These financial results were for the
15 last publicly reported fiscal period prior to the consummation of the Merger. The press release
16 reported that advertising, commerce and other revenues reached a record \$649 million and
17 advertising and commerce backlog grew to more than \$3.0 billion. Defendant Pittman stated in
18 the press release that “[o]ur distinctive strategy of focusing on large strategic marketing
19 agreements with major mainstream companies is paying off in the continuing strength of our
20 advertising and commerce revenues, which will substantially benefit from the merger.”

21 188. In a conference call with analysts on October 18, 2000 following the release of
22 the quarterly results, then AOL President, Defendant Pittman, responded to a question regarding
23 whether AOL was feeling the effects of an industry-wide slowdown in advertising as follows: “I
24 don’t see it and I don’t buy it.” In the same telephone conference, Defendant Case, AOL’s
25 Chairman and CEO at the time, said “AOL’s advertising growth is right on target. . . . The
26 current advertising environment benefits us because it will drive a flight to quality.” Defendant
27 Kelly, then AOL’s CFO, similarly characterized AOL’s advertising and commerce revenue
28 growth as “very healthy” and emphasized, “I can’t say that strongly enough.” Defendant Kelly

1 reiterated his prior predictions that AOL Time Warner's revenue will rise 12% to 15% annually
2 and the merged company's EBITDA would rise 30% in the Company's first year.

3 189. The market responded very favorably to the financial results released by AOL
4 midday on October 18, 2000, and the stock rose over 7% to \$46.91 per share at the close of the
5 market on October 18, 2000, up from a price of \$43.60 per share at the close of the market on
6 October 17, 2000.

7 190. On or about October 19, 2000, Christopher Dixon, a PaineWebber Inc. analyst,
8 wrote that AOL's strong advertising and commerce revenue "should alleviate some concerns
9 about the health of the Internet advertising environment."

10 191. On or about November 2, 2000, the AOL Individual Defendants caused AOL to
11 issue its 1999 Annual Report for the fiscal year ended June 30, 1999, in which Defendants Case
12 and Pittman touted AOL's remarkable advertising revenue growth:

13 In short, we are pleased to say that America Online has never been stronger. Our
14 fiscal 1999 highlights include....Advertising, commerce and other revenues
climbed 84% to \$1 billion, with a backlog of committed revenue of \$1.5 billion.

15 * * *

16 During fiscal 1999, we signed 58 multi-year advertising and commerce
17 agreements, each worth in excess of \$1 million.

18 The 1999 Annual Report also appended AOL's Form 10-K for the fiscal quarter and year ended
19 June 30, 1999 filed August 13, 1999. For the reasons discussed above, the Form 10-K and related
20 statements regarding AOL's advertising revenue for the quarter and year ended June 30, 1999
21 were materially false and misleading.

22 192. On November 9, 2000, the AOL Individual Defendants caused AOL to file its
23 Form 10-Q for the fiscal quarter ended September 30, 2000. The Form 10-Q was signed by
24 Defendants Case and Kelly. It contained substantially the same financial information as the
25 October 18, 2000 press release, including \$649 million in advertising, commerce and other
26 revenue, an 80% increase over the year ago quarter, and a \$3 billion advertising and commerce
27 backlog. The Form 10-Q also stated that AOL had \$534 million in advertising and commerce
28

1 revenue, a 95% increase over the year ago quarter. In addition, the Form 10-Q assured investors
2 that AOL's financials were prepared in accordance with GAAP:

3 The accompanying unaudited condensed consolidated financial statements, which
4 include the accounts of America Online, Inc. (the "Company") and its wholly
5 owned subsidiaries, have been prepared in accordance with generally accepted
6 accounting principles for interim financial information and with the instructions to
7 Form 10-Q and Article 10 of Regulation S-X.

8 193. In fact, AOL's reported advertising and commerce revenue for the quarter ended
9 September 30, 2000 of \$534 million was overstated by \$156 million, an overstatement of the
10 actual advertising and commerce revenue by at least 41%, as a result of AOL's improper
11 accounting for the Sun (\$12.6 million), Gateway (\$85 million), 24dogs.com (\$16.2 million),
12 Homestore (\$6.6 million), Monster.com (\$6.2 million), Ticketmaster (\$13 million) and eBay
13 (\$16.8 million) deals, as discussed above. For the same reasons, AOL's reporting of advertising,
14 commerce and other revenue was likewise overstated by \$156 million for the quarter. The
15 Company has already admitted overstatement of \$66 million of AOL advertising and commerce
16 revenue for the quarter ended September 30, 2000, based on its restatement of that period's
17 financial statements.

18 194. AOL's October 18, 2000 press release and related Form 10-Q filing stating that its
19 advertising revenue backlog as of September 30, 2000 was \$3 billion was also false because the
20 actual backlog was overstated by at least \$1 billion, or by at least 51%, due to the improper
21 accounting of the Sun (\$58.8 million), Hughes (\$389 million), Homestore.com (\$68.4 million),
22 Monster.com (\$79 million), Gateway (\$286.8 million), 24dogs.com (\$7.5 million), Veritas (\$20
23 million), Telefonica SA (\$15 million), PurchasePro (\$41.4 million) and WorldCom (\$48.9
24 million) deals.

25 195. The statements made by Defendants Case, Pittman and Kelly to market analysts
26 on the conference call of October 18, 2000 are also false and misleading for the same reasons,
27 and were particularly egregious in light of the internal AOL information showing that \$140
28 million of AOL advertising revenue was "at risk" for the following calendar year.

196. On October 30, 2000 the AOL Individual Defendants caused the Company to file
a Form 10-K/A for the quarter and fiscal year ended June 30, 2000 in which the Company

1 reiterated the advertising and commerce revenue and advertising and commerce backlog
2 previously reported for the quarter and year ended June 30, 2000, again overstating AOL's
3 financial results for the period, as previously discussed.

4 i. **The Fiscal Quarter and Year Ended December 31, 2000**

5 197. On January 11, 2001, the Individual Defendants caused the Company to issue a
6 press release announcing that the Merger between AOL and Time Warner had been completed
7 that day, creating AOL Time Warner.

8 198. One day after the Merger was consummated, on January 12, 2001, *The Wall*
9 *Street Journal* reported that despite the weakening advertising market, AOL Time Warner was
10 standing by its revenue targets for the merged company and that advertising and e-commerce
11 would remain the fastest growing revenue source for the Company:

12 Mike Kelly, AOL's chief financial officer and holder of the same title at the new
13 company, said yesterday that executives are sticking by their targets, which call
14 for revenue to grow by 12% to 15% to total more than \$40 billion in 2001, and for
15 earnings before interest, taxes, depreciation and amortization to rise about 30% to
16 \$11 billion. He added that the new AOL Time Warner had always planned to
17 aggressively look for cost savings and ways to generate extra revenue.

18 Analysts' concerns intensified last month after Time Warner warned that its
19 fourth-quarter earnings would be hurt by weaker ad revenue.... At the time, AOL
20 said its fourth-quarter advertising and online commerce revenues were "on track"
21 to meet Wall Street expectations.

22 Mr. Kelly said yesterday he still expected advertising and e-commerce "would be
23 our fastest-growing revenue component."

24 199. On January 12, 2001, the Individual Defendants caused the Company to file a
25 Form 8-K dated January 11, 2001 and signed by Defendant Cappuccio that incorporated the
26 Merger Agreement between AOL and Time Warner, which contains materially false
27 representations and warranties by AOL as discussed herein at ¶ 307.

28 200. On January 26, 2001, the Individual Defendants caused the Company to file a
Form 8-K/A dated January 11, 2001. The Form 8-K/A was signed by Defendant Kelly and Barge
and incorporated the AOL Time Warner consolidated balance sheet as of September 30, 2000
and AOL Time Warner's pro forma consolidated condensed financial statements for the three
months ended September 30, 2000, year ended June 30, 2000 and year ended December 31,

1 1999, which were materially misleading because they incorporated the fraudulently inflated AOL
2 advertising revenue for the respective fiscal periods, as discussed above.

3 201. Similarly, on January 26, 2001, the Individual Defendants caused the Company to
4 file a Form 8-K/A amending a Form 8-K dated January 18, 2001 that updated the financial
5 results for the quarter ended September 30, 2000 and reiterated the advertising and commerce
6 revenue and backlog previously reported for the quarter, again overstating AOL's financial
7 results for the period, as discussed above.

8 202. On January 31, 2001, the Individual Defendants caused the Company to report the
9 first financial results since the Merger was consummated, including "all-time records" in AOL
10 advertising revenue. The press release represented that AOL achieved all-time records in
11 revenues, advertising, commerce and other revenues. operating income, EBITDA and AOL
12 membership growth with advertising commerce and other revenues reaching \$741 million. The
13 Company further reported AOL Time Warner's pro forma results for full year 2000 and stated
14 that full-year advertising and commerce revenues increased 24% to more than \$8.7 billion and
15 that advertising and commerce revenues were \$2.6 billion for the December 2000 quarter.

16 203. On January 31, 2001, *Dow Jones Business News* reported that the strong revenue
17 growth for the merged Company's first quarter was boosted by a remarkable increase in
18 advertising, commerce and other revenue and quoted Defendant Pittman as stating "[w]e are
19 seeing exciting momentum in our subscription and advertising/commerce businesses across the
20 company. AOL's revenue rose 27% to \$2.06 billion, boosted in part by a 65% jump in revenue
21 from advertising, commerce and related activities."

22 204. On January 31, 2001, *Dow Jones News Service* reported that Defendant Kelly
23 reiterated the Company's ambitious 2001 growth targets which included 2001 revenue of \$40
24 billion, compared with pro forma revenue of \$36.2 billion in 2000. As stated by Kelly, "[t]he
25 guidance that we gave over a year ago remains unchanged."

26 205. On January 31, 2001, *Business Wire* reported that Defendant Kelly said:

27 "Strong growth in subscription and advertising revenues will drive the Company's
28 performance, with the benefit of multiple revenue streams from a diverse array of

1 world class brands and customer relationships. AOL Time Warner has all the
2 financial strength necessary to back our vision for the future.”

3 (Emphasis added).

4 206. On February 1, 2001, *The Los Angeles Times* reported that AOL Time Warner
5 again told investors they shouldn’t worry about the newly merged company meeting its financial
6 targets because advertising revenue growth at AOL would continue to boost the Company’s total
7 revenues, despite the slowing advertising market.

8 207. On February 13, 2001, *Dow Jones News Service* reported that AOL Time Warner
9 again emphasized the AOL unit’s advertising and commerce revenue to assure investors that the
10 merged Company’s revenue growth would remain strong:

11 Michael Kelly said the AOL side of the business would be the “catalyst for
12 change across the whole company.”

13 AOL Time Warner expects the fastest-growing segment of its business to be
14 advertising and commerce revenue. Revenue in this area rose 29% last year, on a
15 pro forma basis, with the AOL side posting the sharpest growth. For 2001, AOL
16 Time Warner expects advertising/commerce revenue to rise 18% to 22%.

17 (Emphasis added.)

18 208. On March 8, 2001, *Dow Jones News Service* reported that Individual Defendants
19 represented that the increasing weakness in the advertising market would not affect AOL Time
20 Warner’s advertising business:

21 Despite increasing signs of a weak advertising market, AOL Time Warner Inc.
22 (AOL) Chief Operating Officer Bob Pittman reaffirmed the company’s ambitious
23 financial targets for 2001.

24 Speaking at the Merrill Lynch Internet Conference in New York today, Pittman
25 put it bluntly: “our businesses are doing great.”

26 While acknowledging that the overall advertising market has weakened, he said
27 AOL Time Warner remains strong because its numerous properties make it a
28 must-buy for advertisers.

“I want to assure you we gave The Street our guidance in January and we are
sticking to it. Period,” he said.

Pittman said, “[I]n addition, the soft economy has sparked a “flight to quality”
among advertisers, who are shifting their spending to AOL Time Warner from its
competitors.”

1 209. On March 8, 2001, Lehman Brothers, Inc., issued an analyst report on AOL Time
2 Warner in which it rated the Company's common stock a "Buy." In making the recommendation,
3 the analyst report relied heavily on the reported strength of the AOL division's advertising
4 business.

5 210. On March 27, 2001, the Individual Defendants caused AOL Time Warner to issue
6 its 2000 Annual Report in which Defendants Case and Levin touted the Company's phenomenal
7 advertising revenue growth:

8 The ability to monetize the fundamental building blocks of value that we possess
9 is rooted in multiple revenue streams from subscriptions, advertising and
10 commerce, and content.... Continuing to capitalize on its status as the premier
Internet brand, America Online extended its industry-leading position in
advertising and commerce, growing its base by a remarkable 91% last year.

11 The Annual Report continued:

12 Advertising and commerce revenues increased by 91%, from \$1.240 million
13 during the year ended December 31, 1999 to \$2.369 million during the year ended
14 December 31, 2000. This increase was primarily attributable to additional
advertising and electronic commerce on America Online's AOL service, as well
as its other branded services and portals.

15 211. On March 27, 2001, the Individual Defendants caused AOL Time Warner to file
16 its Form 10-K for the transition period from July 1, 2000 to December 31, 2000. The Form 10-K
17 was signed by Defendants Case, Levin, Kelly, Pittman and Parsons. It contained substantially the
18 same financial information as the January 31, 2000 press release, including \$686 million in
19 advertising and commerce revenue at the AOL unit for the quarter ended December 31, 2000.
20 The Form 10-K also stated that AOL advertising and commerce revenue was \$1.3 billion for the
21 six months and \$2.4 billion for the year ended December 31, 2000, a 91% increase over the year
22 ended December 31, 1999. Starting with this financial report, the Company discontinued the
23 reporting of advertising and commerce backlog.

24 212. In addition, the Form 10-K incorporated, with its consent, the January 31, 2001
25 report of Defendant Ernst & Young, which assured investors that AOL's financials were audited
26 in accordance with GAAS and found to be compliant with GAAP:

27 We conducted our audit in accordance with auditing standards generally accepted
28 in the United States We believe that our audits provide a reasonable basis for
our opinion.

1 In our opinion, the financial statements referred to above present fairly, in all
2 material respects, the consolidated financial position of America Online, Inc. at
3 December 31, 2000 and 1999, and the consolidated results of its operations and its
cash flows for each of the three years in the period ended December 31, 2000, in
conformity with accounting principles generally accepted in the United States.

4 213. The Form 10-K further stated that “An important component of America Online’s
5 strategy is to continue increasing revenues from advertising”

6 214. In fact, AOL’s advertising and commerce revenue reported in its financial
7 statements of \$686 million for the quarter, \$1.3 billion for the six months and \$2.4 billion for the
8 year ended December 31, 2000, was overstated by at least \$186.8 million, \$343 million and
9 \$678.1 million, respectively, an overstatement of the actual advertising and commerce revenue
10 by at least 37%, 37%, and 40%, respectively, as a result of AOL’s improper accounting. The
11 overstatement of at least \$186.8 million for the quarter was due to AOL’s improper accounting
12 of the Sun (\$12.6 million), eBay (\$16.8 million), Gateway (\$85 million), 24dogs.com (\$7.5
13 million), Homestore.com (\$6.6 million), Veritas (\$4 million), Telefonica SA (\$10 million),
14 WorldCom (\$12.7 million), Monster.com (\$6.2 million) and PurchasePro (\$25.4 million) deals.
15 The overstatement of at least \$343 million for the six months ended December 31, 2000 was due
16 to AOL’s improper accounting for the Sun (\$25.2 million), Gateway (\$170 million), eBay (\$33.6
17 million), 24dogs.com (\$23.7 million), Veritas (\$4 million), Telefonica SA (\$10 million),
18 WorldCom (\$12.7 million), Homestore.com (\$13.2 million), Monster.com (\$12.5 million),
19 PurchasePro (\$25.4 million) and Ticketmaster (\$13 million) deals. The overstatement of at least
20 \$678.1 million for the calendar year ended December 31, 2000 was due to AOL’s improper
21 accounting for the Sun (\$50.4 million), eBay (\$67.2 million), Homestore (\$17.6 million), Hughes
22 (\$180 million), Gateway (\$340 million), 24dogs.com (\$23.7 million), Veritas (\$4 million),
23 Telefonica SA (\$10 million), WorldCom (\$12.7 million), Monster.com (\$25 million),
24 PurchasePro (\$25.4 million), Ticketmaster (\$13 million) and Dr.Koop.com (\$9.6 million) deals.
25 215. Through its restatement, the Company has already admitted overstatements of \$22
26 million, \$88 million and \$88 million, of AOL advertising and commerce revenue for the quarter,
27 six months and year ended December 31, 2000, respectively.

1 216. The oral statements made by Defendant Kelly as reported by *The Wall Street*
2 *Journal* on January 12, 2001, Kelly's comments to market analysts on January 31, 2001 and
3 Defendant Pittman's comments at the Merrill Lynch Internet Conference on March 8, 2001, as
4 reproduced above, are also false and misleading. Indeed, the representations that the advertising
5 market slowdown would not adversely affect the advertising revenue growth at AOL were
6 patently misleading and false for the reasons discussed above and in light of internal information
7 within AOL which showed that AOL was at risk to lose substantial advertising revenue.

8 **j. The Fiscal Quarter Ended March 31, 2001**

9 217. On April 2, 2001, *The Wall Street Journal* reported that AOL Time Warner was
10 one of a few large companies continuing to see sharp gains in stock price despite a softening
11 economy and weak stock market:

12 In a rocky stock market, [AOL Time Warner] is one of few big companies whose
13 stock has shown a sharp gain so far this year, partly because it has stuck by
14 aggressive revenue and earnings targets. The newly merged company, facing a
15 weakening economy, is pulling out all the stops to meet its original forecasts for
16 2001: 12% to 15% growth in revenue, to \$40 billion, and a 30% increase in
earnings before interest, taxes, depreciation and amortization, to \$11 billion. The
company says not to worry, and many analysts and investors are confident it will
deliver.

17 218. On April 3, 2001, *AFX News* quoted Defendant Levin as stating the Company was
18 "on track."

19 219. On April 16, 2001, *Barron's* reported that the Individual Defendants predicted
20 strong advertising revenue for the Company's fiscal quarter driven by the Company's AOL
21 division, commenting that "AOL may be immune to the down cycle in the media."

22 220. On April 18, 2001, the Individual Defendants caused the Company to issue a
23 press release announcing its financial results for the quarter ended March 31, 2001, including
24 strong revenue gains for the Company, driven by large gains in advertising and commerce
25 revenue at the AOL unit. Specifically, the press release represented that total revenues rose 9%
26 to \$9.1 billion, compared to \$8.3 billion in the 2000 first quarter and that the revenue growth was
27 driven in part by a 10% increase in advertising and commerce revenues to \$2.1 billion. The
28

1 press release further reported stated that: "strong growth in advertising and commerce revenues
2 were led by year-over-year increases of 37% at America Online."

3 221. On April 18, 2001, *AFX News* reported that the strong revenue growth reported by
4 AOL Time Warner in its first quarter as a merged entity helped the Company significantly
5 exceed forecasts of earnings per share:

6 AOL reported a rise in first quarter cash earnings per share to 23 cents from a pro-
7 forma 19 cents a year ago, beating Wall Street consensus forecasts by 3 cents.

8 Speaking after the release of the figures, AOL Time Warner chief executive
9 officer Gerald Levin said the company is "on track" to meet its full-year revenue
10 and EBITDA targets.

11 "I think we have made an excellent start," Levin said during a conference call.

12 Analysts, who had feared the slowdown in online advertising may have hit the
13 group's performance, were buoyed by the figures.

14 In a note to clients, Merrill Lynch described the company's results as
15 "impressive."

16 Salomon Smith Barney was equally upbeat.

17 222. On April 18, 2001, *Dow Jones News Service* reported that Individual Defendants
18 told the investing public that strong advertising and commerce revenue at the AOL division
19 would be instrumental in achieving the Company's fiscal year goals:

20 AOL Time Warner Inc. expects the advertising market to improve in the second
21 half of the year, Chief Financial Officer Michael Kelly said Wednesday.

22 * * *

23 "I'd say we are assuming the second half of the year will see some strengthening
24 of the ad markets," Kelly said during a conference call Wednesday after AOL
25 Time Warner reported better-than-expected first-quarter results.

26 * * *

27 An improving advertising market could be key to helping AOL Time Warner
28 meet its ambitious financial targets for 2001. Chief executive Jerry Levin said
first-quarter results put the company "on track" to meet those targets.

223. On April 19, 2001, Lehman Brothers, Inc., and Merrill Lynch both issued positive
analyst reports on AOL Time Warner in which they specifically noted the strength of the
Company's advertising revenues.

1 224. On April 19, 2001, *The Los Angeles Times* reported in an article titled, "Company
2 Town AOL Time Warner Restores Confidence with Strong First-Quarter Earnings," that the
3 surprisingly strong revenue growth in advertising and commerce had a significant positive
4 impact on the market's confidence in the Company:

5 AOL Time Warner Inc. delivered surprisingly solid earnings Wednesday to a
6 wary Wall Street, putting to rest--for now--doubts about the media and
7 entertainment giant's ability to hit its financial targets amid the advertising
8 slowdown. Fueled by double-digit growth at its Internet and cable businesses, the
9 New York-based company said first-quarter revenue rose 9% to \$9.1 billion.
Quarterly earnings, before certain costs, soared 20% to \$2.1 billion. The strong
showing was in sharp contrast to those of other Internet and media companies,
which have disappointed investors in recent weeks with rising losses and falling
sales. . . .

10 Even with a solid first-quarter performance, the company will have to work
11 overtime to meet its year-end goal of generating \$40 billion in revenue and \$11
12 billion in earnings ...AOL Time Warner's chief executive, Gerald Levin,
13 reiterated those targets Wednesday and said his company is not as vulnerable as
14 others to the ad slowdown. 'Our company rides above the normal market
15 dynamics.' Levin said ... Advertising and e-commerce revenue--a trouble spot at
many Internet companies--rose 10% during the quarter, thanks largely to increase
at the flagship AOL Internet service and the Time Warner cable business.

16 (Emphasis added.)

17 225. On April 19, 2001, *The Wall Street Journal* reported that AOL Time Warner's
18 growth in online advertising and its confidence in its previously stated goals for fiscal 2001 set
19 the Company apart from other companies in the online advertising business.

20 226. On May 4, 2001, the *San Jose Mercury News* reported that Defendant Case
21 boasted of the unusually strong advertising and commerce revenue at the AOL unit:

22 As Internet stocks flounder around him AOL Time Warner Chairman Steve Case
23 on Thursday boasted that his company is hitting Wall Street targets ... The merged
company announced financial results last month that were in line with
expectations of most analysts. He pointed out that even as Internet advertising has
declined for others, AOL operations reported advertising and e-commerce, had
increased 37 percent.

24 227. On or about May 15, 2001, the AOL Individual Defendants caused the Company
25 to file its Form 10-Q for the Company's first fiscal quarter as a merged entity ended March 31,
26 2001 and subsequently caused the Company to file a Form 10-Q/A for the same period on May
27 16, 2001. The Form 10-Q and Form 10-Q/A was signed by Defendant Kelly and contained
28 substantially the same financial information as the April 18, 2001 press release, including the

1 37% increase in advertising and commerce revenue for AOL, which means that although it was
2 not broken out as such, the Form 10-Q financial results of \$2.1 billion revenue for the AOL
3 business segment included \$721 million in AOL advertising and commerce revenue. In addition,
4 the Form 10-Q and Form 10-Q/A assured investors that the Company's financials were prepared
5 in accordance with GAAP:

6 The accompanying consolidated financial statements are unaudited but, in the
7 opinion of management, contain all the adjustments (consisting of those of a
8 normal recurring nature) considered necessary to present fairly the financial
9 position and the results of operations and cash flows for the periods presented in
10 conformity with generally accepted accounting principles applicable to interim
11 periods.

12 228. In fact, AOL Time Warner's reported AOL segment advertising and commerce
13 revenue for the quarter ended March 31, 2001 of \$721 million was overstated by at least \$214.3
14 million, an overstatement of the actual advertising and commerce revenue by at least 42%, as a
15 result of AOL's improper accounting. The \$214.3 million overstatement was a result of AOL
16 Time Warner's improper accounting for the Sun (\$12.6 million), eBay (\$16.8 million),
17 Homestore.com (\$11.1 million), Gateway (\$130 million), Veritas (\$4 million), Telefonica SA
18 (\$5 million), WorldCom (\$5.3 million), Monster.com (\$6.2), PurchasePro.com (\$7 million), and
19 Bertelsmann (\$16.3 million) deals, as discussed above. By restating its previously issued
20 financial statements, the Company has already admitted overstating at least \$13 million of AOL
21 advertising and commerce revenue for the quarter ended March 31, 2001.

22 229. In addition, the Forms 10-Q and 10-Q/A for the quarter ended March 31, 2001
23 contained a footnote reclassifying certain revenue amounts a year after they were first reported,
24 resulting in a decrease in "advertising, commerce and other" revenue for the quarter ended
25 March 31, 2000. The Forms 10-Q and 10-Q/A failed to specify the origin of the reclassified
26 revenue, continued to inflate AOL's advertising, commerce, and other revenue, and the
27 reclassified revenue amount was substantially less than the amount of the alleged overstatement.
28 Thus, the reclassified advertising revenue remained materially overstated, as set forth above.

1 **k. The Fiscal Quarter Ended June 30, 2001**

2 230. On June 20, 2001, *The Wall Street Journal* reported that concerns about online
3 advertising deals made with PurchasePro led AOL Time Warner to investigate, but the Company
4 stated that it had accounted properly for all revenue related to PurchasePro:

5 America Online suspended top deal maker Eric Keller as part of an investigation
6 into the company's involvement with PurchasePro.com Inc. Mr. Keller is a senior
7 vice president for business affairs at America Online, a unit of New York's AOL
8 Time Warner Inc. He runs a team of negotiators who hammer out deals such as
9 the one with PurchasePro, a start-up business-to-business software firm that this
10 past year agreed to pay America Online \$50 million for a marketing agreement
11 and \$20 million for a software agreement. America Online owns 5.7% of
12 PurchasePro, Las Vegas, and is entitled to a cut of PurchasePro's software
13 revenue.... An America Online spokesman said. 'All revenues related to
14 PurchasePro have been accounted for appropriately and accurately by AOL.'

15 (Emphasis added.)

16 231. On June 21, 2001, *Dow Jones News Service* reported that AOL Time Warner
17 continued to advise the market that its advertising revenue was a reliable revenue source despite
18 the continuing decline in the advertising market:

19 Offering a glimmer of good news for the struggling media industry. AOL Time
20 Warner (AOL) Chief Executive Jerry Levin said advertising revenue at the
21 company has started to stabilize.

22 * * *

23 Earlier this week, a number of top newspaper publishers said that the state of the
24 advertising market remains gloomy. Dow Jones & Co. (DJ), publisher of *The*
25 *Wall Street Journal* and this and other newswires, said the company hasn't seen
26 any improvement in the advertising climate this month.

27 * * *

28 However, AOL has boasted that its diverse media properties have allowed it to
sell lucrative ad packages, helping to cushion the blow of the weakened economy.

29 232. On June 25, 2001, Lehman Brothers, Inc. issued an analyst report on AOL Time
30 Warner in which it rated the Company's common stock a "Buy." In making the recommendation,
31 the Lehman analysts noted: "While the ad market in general still remains in flux ... AOL
32 continues to do deals and remains committed to strong ad/commerce revenue growth this year."

33 233. On July 18, 2001, the Individual Defendants (except for Defendant Keller who
34 was dismissed in June 2001) caused the Company to issue a press release stating that it achieved

1 record financial results for the fiscal quarter ended June 30, 2001, led by a 26% growth in
2 advertising and commerce revenues in the AOL business segment which reached \$706 million.

3 234. On July 18, 2001, *Dow Jones News Service* reported that AOL Time Warner's
4 financial results increased dramatically, due to strong growth in AOL's advertising and
5 commerce revenue:

6 In a prepared statement, chief executive Jerry Levin said, "We couldn't be more
7 proud of what we accomplished this quarter. We achieved outstanding bottom-
8 line results, dramatic improvement in profit margins and a huge increase in Free
Cash Flow. Our record results are further proof that we are delivering on the
promise of the AOL Time Warner merger."

9 America Online's revenue increased 13% to a record \$2.14 billion. AOL's
10 EBITDA improved 37% to a record \$801 million on higher advertising and
commerce revenue, increased operating efficiencies, and reduced network costs
per hour and selling, general and administrative expenses.

11 Levin added, "In just six months, we've made great progress integrating the
12 Company."

13 235. On July 18, 2001, a *Dow Jones News Service* article entitled, "AOL CEO: Co.
14 Was 2nd Largest U.S Advertiser In 2Q," reported that AOL Time Warner was increasing its
15 forecast of 2001 cash earnings growth by ten percent, asserting that the company could continue
16 to grow advertising revenue:

17 "We are assuming only a slight upturn in the (advertising) market in the second
18 half of the year" in the company's networks and publishing units, Kelly said.

19 Kelly said AOL was lifting its forecast of 2001 cash earnings growth to a range of
20 35% to 40%, compared with 2000 levels, from a range of 25% to 30%. Kelly's
remarks came as the New York media and entertainment company reported
second-quarter cash earnings that beat analysts' expectations, but with revenue
that fell short of estimates.

21 One way AOL has responded to the advertising market downturn is to step up its
22 own advertising, filling up unused ad inventory. Levin said AOL was the second-
largest U.S. advertiser in the second quarter: normally, the company is somewhere
23 in the top 10, he said.

24 236. On or about August 14, 2001, the Individual Defendants (except Defendant
25 Keller) caused the Company to file its Form 10-Q for the Company's second quarter ended June
26 30, 2001. The Form 10-Q was signed by Defendant Kelly and contained substantially the same
27 financial information as the July 18, 2001 press release, including a reported 26% increase in
28 advertising and commerce revenue for the AOL business segment over the year ago quarter,

1 which means that although it was not broken out as such, the reported financial results of \$2.1
2 billion in AOL business segment revenue for the quarter included \$706 million in AOL business
3 segment advertising and commerce revenue. The 10-Q also asserted that the “growth in [AOL]
4 advertising and commerce revenues was due to an overall increase in advertising....” The 10-Q
5 also reported a 31% increase in AOL business segment advertising and commerce revenue for
6 the year ended June 30, 2001 over the year ended June 30, 2000. In addition, the 10-Q assured
7 investors that the Company’s financials were prepared in accordance with GAAP:

8 The accompanying consolidated financial statements are unaudited but, in the
9 opinion of management, contain all the adjustments (consisting of those of a
10 normal recurring nature) considered necessary to present fairly the financial
11 position and the results of operations and cash flows for the periods presented in
12 conformity with generally accepted accounting principles applicable to interim
13 periods.

14 237. In fact, AOL Time Warner’s reported AOL segment advertising and commerce
15 revenue for the quarter ended June 30, 2001 of \$706 million was overstated by at least \$150.3
16 million, or an overstatement of the actual advertising and commerce revenue by at least 27%.
17 The overstatement of at least \$150.3 million for the quarter was due to AOL Time Warner’s
18 improper accounting for the Sun (\$12.6 million), eBay (\$16.8 million), Homestore.com (\$11.1
19 million), Veritas (\$4 million), WorldCom (\$5.3 million), Monster.com (\$6.2 million), Oxygen
20 Media (\$19.8), PurchasePro (\$9 million) and Bertelsmann (\$65.5) deals. The Company has
21 already admitted that at least \$28 million for the quarter and \$41 million for the six months
22 ended June 30, 2001, respectively of AOL advertising and commerce revenue was overstated
23 based on its restatement of the quarter’s results.

24 238. In addition, the Form 10-Q for the quarter ended June 30, 2001 contained a
25 footnote reclassifying certain revenue amounts, a year after they were first reported, resulting in
26 a decrease in “advertising, commerce and other” revenue for the quarter ended June 30, 2000.
27 The 10-Q failed to specify the origin of the reclassified revenue, continued to inflate AOL’s
28 advertising, commerce and other revenue, and the reclassified revenue amount was substantially
29 less than the amount of the alleged overstatement. Thus, the reclassified advertising revenue
30 remained materially overstated, as set forth above.

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1 the quarter, a 5% increase over the year ago quarter. The 10-Q also reported advertising and
2 commerce revenue for the AOL business segment for the nine months ended September 30, 2001
3 of \$2.051 billion, a 22% increase over the prior year.

4 242. In addition, the Form 10-Q assured investors that the Company financials were
5 prepared in accordance with GAAP:

6 The accompanying consolidated financial statements are unaudited but, in the
7 opinion of management, contain all the adjustments (consisting of those of a
8 normal recurring nature) considered necessary to present fairly the financial
9 position and the results of operations and cash flows for the periods presented in
10 conformity with generally accepted accounting principles applicable to interim
11 periods.

12 243. In fact, AOL Time Warner's reported AOL segment advertising and commerce
13 revenue of \$624 million for the quarter and \$2.1 billion for the nine months ended September 30,
14 2001, was overstated by at least \$122.1 million and \$486.7 million, respectively, or at least 24%
15 and 31%, respectively, as a result of AOL Time Warner's improper accounting. The
16 overstatement of at least \$122.1 million for the quarter was due to AOL Time Warner's improper
17 accounting for the Sun (\$12.6 million), eBay (\$12.8 million), Oxygen Media (\$19.8 million),
18 Veritas (\$4 million), WorldCom (\$5.3 million), Homestore (\$6.6 million), Monster.com (\$6.2
19 million), Golf Channel (\$15 million) and Bertelsmann (\$39.8 million) deals, as discussed above.
20 The overstatement of at least \$486.7 million for the nine months ended September 30, 2001 was
21 due to AOL Time Warner's improper accounting for the Sun (\$37.8 million), eBay (\$46.4
22 million), Homestore.com (\$28.8 million), Oxygen Media (\$39.6 million), Veritas (\$12 million),
23 Telefonica SA (\$5 million), WorldCom (\$15.9 million), Gateway (\$130 million), Monster.com
24 (\$18.6 million), PurchasePro (\$16 million), Golf Channel (\$15 million) and Bertelsmann (\$121.6
25 million) deals.

26 244. The Company has already admitted overstating \$16 million, and \$57 million of
27 AOL advertising and commerce revenue for the fiscal quarter and nine months ended September
28 30, 2001, respectively, based on its restatement of those financial results.

245. In addition, the Form 10-Q for the quarter ended September 30, 2001 contained a
footnote reclassifying certain revenue amounts, a year after they were first reported, resulting in

1 a decrease in “advertising, commerce and other” revenue for the quarter ended September 30,
2 2000. The Form 10-Q failed to specify the origin of the reclassified revenue and continued to
3 inflate AOL’s advertising, commerce and other revenue, and the reclassified revenue amount
4 was substantially less than the amount of the alleged overstatement. Thus, the reclassified
5 advertising revenue remained materially overstated, as set forth above.

6 **m. The Fiscal Quarter and Year Ended December 31 , 2001**

7 246. On November 27, 2001, a *Dow Jones News Service* article titled, “AOL Co-COO
8 Backs ‘02 Double-Digit Cash Flow Growth View” reported that despite the economic downturn,
9 AOL Time Warner was holding to its ambitious targets for the year ended December 31, 2002:

10 AOL Time Warner Inc. (AOL) Co-Chief Operating Officer Bob Pittman said he’s
11 comfortable with the company’s previous estimate of posting a “double-digit”
cash flow growth rate in 2002.

12 The media and Internet company said in late September it expected earnings
13 before interest, taxes, depreciation and amortization, or EBITDA, to rise by a
14 double-digit percentage in 2002. At the same time, AOL lowered its forecasts for
this year, citing the weak economy and advertising market. It expects EBITDA to
rise 20% in 2001.

15 “We’re comfortable with the double-digit EBITDA growth” in 2002, Pittman told
16 investors at the Credit Suisse First Boston technology conference in Scottsdale,
Ariz. “We have enough control of our destiny to be comfortable.”

17 247. On January 30, 2002, the Individual Defendants (except Defendant Keller) caused
18 the Company to issue a press release with financial results for the fiscal quarter and year ended
19 December 31, 2001, which included a year-over-year increase in AOL advertising and commerce
20 revenue for the year of 13% to \$2.7 billion, and AOL advertising and commerce revenue of \$637
21 million for the quarter.

22 248. On or about March 25, 2002, the Individual Defendants (except Defendant Keller)
23 caused the Company to file its Form 10-K for the fiscal quarter and year ended December 31,
24 2001. The Individual Defendants (except Keller) subsequently caused the Company to file a
25 Form 10-K/A on March 26, 2002 for the fiscal quarter and year ended December 31, 2001. The
26 Forms 10-K and 10-K/A contained substantially the same financial information as the January
27 30, 2002 press release, including \$637 million and \$2.7 billion in AOL advertising and
28 commerce revenue, and \$2.2 billion and \$8.5 billion in AOL Time Warner advertising and

1 commerce revenue, respectively, for the fiscal quarter and year ended December 31, 2001. The
2 Forms 10-K and 10-K/A were signed by, among others, Defendants Case, Levin, Pace, Parsons
3 and Pittman.

4 249. The Forms 10-K and 10-K/A further stated:

5 While advertising revenues declined overall, certain segments and businesses of
6 AOL Time Warner experienced an increase in advertising revenues. Specifically,
7 and as discussed in more detail below under Business Segment Results,
advertising revenues increased at the AOL and Cable segments, and at The WB
Network.

8 250. The Form 10-K and Form 10-K/A also incorporated, with the consent of
9 Defendant Ernst & Young, the January 28, 2002 report of Ernst & Young which assured
10 investors that the Company's financials were audited in accordance with GAAS and were
11 prepared in compliance with GAAP:

12 We conducted our audit in accordance with auditing standards generally accepted
13 in the United States We believe that our audits provide a reasonable basis for
our opinion.

14 In our opinion, the financial statements referred to above present fairly, in all
15 material respects, the consolidated financial position of AOL Time Warner at
December 31, 2001 and 2000, and the consolidated results of its operations and its
16 cash flows for each of the three years in the period ended December 31, 2001, in
conformity with accounting principles generally accepted in the United States.
17 Also, in our opinion, the related financial statement schedule and supplementary
information, when considered in relation to the basic financial statements taken as
a whole, present fairly in all material respects the information set forth therein.

18 251. On March 27, 2002, AOL Time Warner issued its 2001 Annual Report in which
19 Defendants Case, Parsons and Pittman emphasized the growth in advertising revenue compared
20 to the previous year, noting there was "a 13% increase in AOL advertising and commerce
21 revenues from \$2.369 billion to \$2.688 billion."

22 252. In fact, AOL Time Warner's reported AOL segment advertising and commerce
23 revenue of \$637 million for the quarter and \$2.7 billion for the year ended December 31, 2001
24 was overstated by at least \$60.3 million, and \$547.2 million, respectively, or an overstatement of
25 the actual advertising and commerce revenue by at least 10% and 26%, respectively, as a result
26 of AOL's improper accounting. AOL Time Warner's reported advertising and commerce
27 revenue for the quarter and year ended December 31, 2001 was similarly overstated by at least
28

\$60.3 million and \$547.2 million, respectively, as a result of the Company's improper accounting. The quarterly overstatement was due to AOL Time Warner's improper accounting for the Sun (\$8.4 million), Oxygen Media (\$19.8 million), Gateway (\$3 million), Veritas (\$4 million), WorldCom (\$11.8 million), Homestore (\$6.6 million), Monster.com (\$6.2 million) and Bertelsmann (\$0.5) deals, as discussed above. The overstatement of at least \$547.2 million for the year ended December 31, 2001 was due to AOL Time Warner's improper accounting for the Sun (\$46.2 million), eBay (\$46.4 million), Homestore.com (\$35.4 million), Oxygen Media (\$59.4 million), PurchasePro (\$16 million), Gateway (\$133 million), Veritas (\$16 million), Telefonica SA (\$5 million), WorldCom (\$27.7 million), Monster.com (\$25 million), Golf Channel (\$15 million) and Bertelsmann (\$122.1 million) deals, as discussed above.

253. By its restatement, the Company has admitted overstating AOL advertising and commerce revenue for the quarter and year ended December 31, 2001 by \$17 million and \$74 million, respectively.

n. The Fiscal Quarter Ended March 31, 2002

254. By March 2002, the advertising market had become so bleak, that the Company was forced to acknowledge a significant impact on its AOL advertising business. Nevertheless, AOL secretly continued to artificially inflate its advertising revenue.

255. Indeed, on or about May 6, 2002, the Individual Defendants (except Defendant Keller) caused the Company to file its Form 10-Q for the Company's fiscal quarter ended March 31, 2002. The Form 10-Q reported \$501 million in AOL advertising and commerce revenue for the quarter ended March 31, 2002. In addition, the Form 10-Q assured investors that the Company's financials were prepared in accordance with GAAP:

The accompanying consolidated financial statements are unaudited but, in the opinion of management, contain all the adjustments (consisting of those of a normal recurring nature) considered necessary to present fairly the financial position and the results of operations and cash flows for the periods presented in conformity with generally accepted accounting principles applicable to interim periods.

256. In fact, AOL Time Warner's reported AOL segment advertising and commerce revenue for the quarter ended March 31, 2002, of \$501 million was overstated by \$130.4 million,

1 or at least 35%, as a result of AOL's improper accounting, as discussed above. The \$130.4
2 million overstatement is due to AOL Time Warner's improper accounting for the Oxygen Media
3 (\$19.8 million), Gateway (\$9 million), Monster.com (\$6.2 million), Homestore (\$6.6 million),
4 WorldCom (\$8.5 million) and Bertelsmann (\$80.3 million) deals, as discussed above. The
5 Company has already admitted an overstatement of at least \$6 million in advertising and
6 commerce revenue for the quarter through its restatement of that period's financial statements.

7 257. The Form 10-Q for the quarter ended March 31, 2002 also stated that the
8 advertising and commerce revenue for AOL Time Warner the quarter ended March 31, 2001 was
9 \$17 million less than originally reported a year previously, but failed to identify the origin of the
10 reduced revenue and whether the decrease related to AOL. The 10-Q again overstated the
11 Company's advertising and commerce revenue for that quarter, as previously discussed.

12 o. **The Fiscal Quarter Ended June 30, 2002**

13 258. On July 24, 2002, Individual Defendants, including Defendants Pace and Parsons,
14 held a conference call with market analysts after the Company issued a press release announcing
15 the Company's financial results for the quarter ended June 30, 2002. The press release was
16 issued and the conference call took place after the stock market had closed on July 24, 2002.
17 During the conference call, Defendant Pace stated that the AOL division had \$412 million in
18 advertising and commerce revenue in the quarter ended June 30, 2002, \$342 million of which
19 was advertising revenue. Pace also stated that the advertising and commerce backlog as of June
20 30, 2002 was \$860 million. Also during the call, Defendant Parsons stated that the SEC was
21 conducting an investigation into the Company's accounting practices with respect to AOL
22 advertising revenue in reaction to allegations raised in articles published by *The Washington Post*
23 on July 18 and 19, 2002.

24 259. In fact, AOL Time Warner's reported AOL segment advertising and commerce
25 revenue of \$412 million and advertising revenue of \$342 million for the quarter ended June 30,
26 2002, were both overstated by at least \$126 million. The overstatement was due to AOL Time
27 Warner's improper accounting for the Oxygen Media (\$19.8 million), Homestore (\$6.6 million),
28 Monster.com (\$6.2 million), Bertelsmann (\$84.4 million) and Gateway (\$9 million) deals, as

discussed above. Further, Defendant Pace's statement in the July 24, 2002 press release that AOL Time Warner's AOL segment advertising revenue backlog as of June 30, 2002 was \$860 million was false because the actual backlog was overstated by at least \$212.8 million, or at least 33%, due to the improper accounting of the Homestore.com (\$13.2 million), Monster.com (\$35.4 million), Gateway (\$51 million), and Bertelsmann (\$113.2 million) deals. Accordingly, notwithstanding the extremely weak advertising market that left the Company no choice but to report decreased advertising revenue, and acknowledgement by the Company of the SEC investigation, the Company still artificially inflated its reported advertising revenue and backlog.

260. On July 24, 2002, AOL Time Warner stock closed at \$11.40 per share. Following the Company's disclosure of the SEC investigation after the market closed on July 24, 2002, the stock fell 15.4% to close at \$9.64 per share at the end of trading on July 25, 2002.

261. Based on the foregoing, the Company, AOL, the Individual Defendants and Defendant Ernst & Young, made material misrepresentations and omitted material facts, in SEC filings, press releases, financial statements, and AOL Time Warner's consolidated pro forma financial statements referred to above, which were incorporated into the Merger Registration Statement, the Joint Proxy Statement-Prospectus and the Stock Option Registration Statements as follows:

(a) Materially overstated AOL and Company advertising and commerce revenue and backlog, and percentage increases of such amounts in year over year comparisons in statements referenced above;

(b) Materially overstated AOL advertising revenue in the consolidated pro forma financial statements in the documents referenced above;

(c) Failed to disclose that AOL and AOL Time Warner had engaged in sham transactions and improper accounting, resulting in the overstated advertising revenue and backlog, and percentage comparisons referenced above;

(d) Failed to disclose in the documents referenced above the true current and anticipated condition of AOL's advertising revenue and advertising business, both before and after the Merger;

1 (e) Falsely represented in the documents referenced above that the subject
2 financial statements were prepared in accordance with GAAP and Article 10 of Regulation S-X;

3 (f) Falsely represented in the documents referenced above that the audited
4 financial statements were audited in conformance with GAAS;

5 (g) Falsely represented in the documents referenced above that the subject
6 financial reports fairly presented the results of the companies' operations, particularly with
7 respect to the advertising and commerce revenue of AOL, including the advertising and
8 commerce revenue of the Company's AOL business segment; and

9 (h) Falsely represented in the documents referenced above the results of the
10 companies' operations, particularly with respect to the advertising and commerce revenue of
11 AOL, and the Company's AOL business segment.

12 262. AOL, the Company and Individual Defendant made numerous statements
13 described above in the companies' press releases, and otherwise to market analysts and the
14 media, that materially overstated AOL and Company advertising revenue and falsely represented
15 or failed to disclose the effect on AOL and the Company of an industry-wide deterioration of the
16 internet advertising market. Such statements include those of Defendants Case, Pittman and
17 Kelly on October 18, 2000, to market analysts as detailed in ¶ 188 above. Other such false and
18 misleading statements include, as discussed above, the following:

- 19 1. Kelly's statements reported by *The Wall Street Journal* on January
20 12, 2001, as set forth in ¶ 198 above;
- 21 2. Kelly's comments to market analysts on January 31, 2001, as set
22 forth in ¶ 204 above;
- 23 3. Pittman's comments at the Merrill Lynch Internet Conference on
24 March 8, 2001, as set forth in ¶ 208 above;
- 25 4. Kelly's and Levin's statements to analysts on April 18, 2001, as set
26 forth in ¶¶ 221-222 above; and
- 27 6. The statements of Case, Pittman, Kelly and others in the AOL and
28 Company press releases announcing financial results throughout the
relevant Class Period, as set forth above.

1 **AOL Time Warner's Overstatement of Goodwill**

2 263. In addition, AOL's artificially inflated advertising revenue caused the value of the
3 Company's goodwill, created as part of the Merger, to be vastly inflated. Indeed, the Company
4 materially overstated the value of goodwill prior to and in conjunction with the Merger and
5 improperly accounted for the goodwill after the Merger, causing it to continue to be greatly
6 overstated.

7 264. Initially, the Company overstated the value of goodwill by knowingly recording
8 an artificially high amount of goodwill due to the fact that AOL's inflated stock price was used
9 to consummate the Merger.

10 265. Goodwill is defined by APB 16 as the premium paid by one company to acquire
11 another when the purchase price exceeds the fair market value of the acquired company's
12 underlying identifiable tangible and intangible assets.

13 266. Since the purchase price (based on AOL's stock price) was artificially high due to
14 the revenue overstatements described above, goodwill was also inflated.

15 267. Following the Merger, under GAAP, AOL Time Warner should have, but failed
16 to, record a charge against earnings for the impairment of its goodwill, based in part on the
17 decreasing value of the AOL division of the Company.

18 268. The Company improperly waited to record the impairment charge until the
19 quarter ended March 31, 2002, as disclosed in the Form 10-Q filed May 6, 2002. At the time, the
20 Company wrote off \$54 billion in a massive charge against assets in its 2002 first quarter
21 financial report, which was characterized by the media as "the largest write-down in history."

22 **Defendants' Course of Conduct Is Revealed**

23 269. On July 18, 2002, *The Washington Post* published the first of two articles, based
24 on statements of former Company employees and confidential documents, which reported
25 allegations that the Company and AOL artificially inflated AOL's advertising revenue, enabling
26 Defendants to report to the public materially false advertising revenue. The article reported that
27 the Company denied the allegations and quoted from a lawyer retained by the Company:
28

1 The accounting for all these transactions is appropriate and in accordance with
2 generally accepted accounting principles The disclosures in AOL's financial
3 statements are appropriate and accurate. AOL's statements provide our investors
4 with all appropriate material information about our business.

5 (Emphasis added.) The article quoted Defendant Ernst & Young as stating that it "stands by its
6 original view that the accounting and disclosures were appropriate."

7 270. Within hours of the publication of *The Washington Post* article, Defendant
8 Pittman abruptly resigned from the Company.

9 271. The second of *The Washington Post* articles regarding the fraud, published the
10 next day, July 19, 2002, further detailed allegations of prior improper reporting of AOL
11 advertising revenues.

12 272. On July 24, 2002, the Company acknowledged that the SEC was investigating its
13 accounting practices in connection with AOL's advertising revenue.

14 273. On July 25, 2002, the *San Jose Mercury News* also reported on the Company's
15 disclosure that the SEC was looking into the Company's accounting practices. The Company's
16 CEO, Defendant Parsons, was quoted in the article as stating "In the current environment, any
17 such allegations will necessarily and appropriately draw inquiry from the appropriate regulatory
18 authorities even where, as here, they are without merit."

19 274. On July 25, 2002, after AOL Time Warner disclosed that the SEC had launched a
20 civil investigation into its accounting practices, several Wall Street analysts immediately
21 downgraded the Company's stock.

22 275. Only after the existence of the SEC investigation regarding the improper
23 recognition of AOL advertising revenue was revealed by the Company did Defendants' improper
24 conduct and its effect become clear to the marketplace. After the Company acknowledged the
25 SEC investigation, AOL Time Warner shares declined by 15.4% to close at \$9.64. Thus, AOL
26 Time Warner common stock had plummeted in value by more than 77% from its trading price of
27 AOL common stock at January 1999 to the Company's trading price in July 2002, as adjusted for
28 stock splits and the Merger. The value of AOL Time Warner stock from when it first started
trading, until the adverse disclosures in July 2002, decreased by 79.9%.

1 276. On July 31, 2002, the Company confirmed that the DOJ had opened a criminal
2 investigation into the Company's accounting practices.

3 277. On or about August 9, 2002, the Company fired Defendant Colburn, the President
4 of AOL's Business Affairs division, who had reported directly to Defendant Pittman.

5 278. On August 14, 2002, the Individual Defendants (except Defendants Keller,
6 Pittman, and Colburn) caused the Company to issue a press release that noted that based on
7 information it claims to have learned in the previous 10 days:

8 The Company had identified three transactions involving its AOL unit with
9 respect to which the Company may conclude, after further investigation, that
10 consideration received by AOL from third parties may have been inappropriately
11 recognized as advertising and commerce revenues. The advertising and commerce
12 revenues recognized in connection with these three transactions totaled
13 approximately \$49 million occurring over a period of six quarters.

14 279. In its Form 10-Q for the second quarter 2002, filed with the SEC on August 14,
15 2002, the Company noted that it may be necessary to restate the results of prior fiscal periods.

16 280. On October 23, 2002, AOL Time Warner publicly stated that its previously
17 announced financial results for each of the quarters ended September 30, 2000 through June 30,
18 2002 were incorrect and had to be restated. For the AOL division, the impact of the adjustments
19 reduced advertising and commerce revenue by \$168 million over the eight quarterly periods.
20 The remaining \$22 million represented a reduction in revenues related to AOL in which the
21 advertising was delivered by other AOL Time Warner divisions. The Company also announced
22 that the review of accounting for advertising transactions was continuing.

23 281. On January 12, 2003, Defendant Case announced that he would step down in
24 May, 2003.

25 282. On January 20, 2003, *The Wall Street Journal* reported that Veritas announced
26 that it was restating some financial results to reflect changes in the accounting for two AOL
27 Time Warner transactions that were being reviewed by the SEC.

28 283. On February 5, 2003, *The Wall Street Journal* reported:

 In an indication that federal authorities are expanding their criminal investigation
of AOL Time Warner Inc.'s America Online unit, the Federal Bureau of
Investigation has sought to question several former PurchasePro.com Inc. officers
in the past few weeks.

1 ...People familiar with the situation said the Department of Justice and the
2 Securities and Exchange Commission are focusing on America Online and some
3 of its former executives, including Eric Keller and David M. Colburn. These
4 people said the investigation, which was launched last summer, is continuing and
5 prosecutors are expected to decide whether to bring charges later this year.
6 Simultaneously, federal prosecutors in Los Angeles are probing America Online's
7 relationship with Homestore Inc. Several former Homestore officials have
8 pleaded guilty to fraud and are cooperating with prosecutors.

9 284. On March 12, 2003, *The Washington Post* reported:

10 The federal investigation of America Online, Inc. and two of its former key
11 executives has been broadened to include alleged "aiding and abetting" of
12 schemes by other companies to artificially inflate reported revenue, sources
13 familiar with the probe said yesterday.

14 Federal investigators are scrutinizing the roles that AOL and two dealmakers.
15 David M. Colburn and Eric Keller, may have played in enabling certain
16 companies, including Homestore Inc., an online real estate firm, to improperly
17 pump up financial results. At the core of the investigation, sources said, Securities
18 and Exchange Commission investigators are examining alleged quid pro quo
19 schemes in which AOL and other companies exchanged cash through sham
20 transactions to falsely boost revenue, both before and after America Online's
21 merger with Time Warner Inc. in January 2001.

22 * * *

23 Investors in Homestore named AOL, Colburn and Keller as defendants in a
24 lawsuit filed last year in California, alleging that the company and its executives
25 made it easier for Homestore to falsify financial results. Last week, a federal
26 judge said she was reluctantly removing the AOL defendants from the case, citing
27 a Supreme Court decision that limits the ability of private parties to seek damages
28 from those who aid wrongdoing rather than perpetrating it themselves.

At the same time, U.S. District Judge Marsha J. Pechman lashed out at AOL. She
noted that the SEC has the explicit legal authority to bring charges of "aiding and
abetting" wrongdoing. "The acts alleged which this Court must accept as true
for purposes of this motion, describe a massive conspiracy driven by pure
avarice," Pechman wrote in her 41-page opinion.

* * *

While dropping the AOL defendants from the Homestore suit, Pechman said they
remain in the cross hairs of a federal probe.

"This decision does not mean that the wrongs of these aiders and abettors will
necessarily go unchecked the [law] expressly granted the SEC the authority to
bring civil actions against aiders and abettors of securities fraud, and it is this
Court's understanding that some investigation is ongoing," she wrote.

285. On March 28, 2003, the Company reported that it might have to restate as much
as an additional \$400 million in AOL advertising revenue as a result of transactions with
Bertelsmann AG that were part of the SEC's investigation. At the same time, the Company

acknowledged that further restatement may be necessary with respect to other transactions being investigated by the SEC and DOJ.

286. On April 1, 2003, *Reuters* reported that Gateway “would delay filing its 2002 annual report by up to 15 days because of plans to restate 2000 and 2001 revenue and costs of goods sold as it reviews transactions with AOL.”

The Materially False and Misleading Statements and Omissions of Material Facts In the Merger Registration Statement and Joint Proxy Statement-Prospectus

287. On February 11, 2000, AOL Time Warner filed with the SEC and disseminated to the public the Merger Registration Statement, which included the Joint Proxy Statement-Prospectus. AOL Time Warner made four amendments to the Merger Registration Statement, the last of which was filed with the SEC on May 19, 2000.

288. The Merger Registration Statement was signed by Defendants Case, Levin, Parsons, Turner, Novack, Pittman, Kelly, Akerson, Barksdale, Bollenbach, Caufield, Gilburne, Hills, Mark, Miles, Raines, Vincent and Cappucio.

289. The Joint Proxy Statement-Prospectus was signed by Defendant Case, as Chairman and Chief Executive Officer of AOL, and Defendant Levin, as Chairman of Time Warner, and sent to shareholders of both companies on or about May 23, 2000.

290. The Merger Registration Statement and Joint Proxy Statement-Prospectus included the Second Amended and Restated Agreement and Plan of Merger (the “Merger Agreement”). The Merger Agreement was attached as Annex A to the Merger Registration Statement and Joint Proxy Statement-Prospectus. In the Merger Agreement, AOL represented and warranted as follows:

4.1 Representations and Warranties of America Online...

* * *

(d) Reports and Financial Statements.

(i) America Online has filed all required registration statements, prospectuses, reports, schedules, forms, statements and other documents required to be filed by it with the SEC since July 1, 1997 (collectively, including all exhibits thereto, the “America Online SEC Reports”).... None of the America Online SEC Reports, as of their respective dates (and, if amended or superseded by a filing prior to the date of this Agreement, then on the date of such filing),

1 contained or will contain any untrue statement of a material fact or omitted or will
2 omit to state a material fact required to be stated therein or necessary to make the
3 statements therein, in light of the circumstances under which they were made, not
4 misleading. Each of the financial statements (including the related notes) included
5 in the America Online SEC Reports presents fairly, in all material respects, the
6 consolidated financial position and consolidated results of operations and cash
7 flows of America Online and its consolidated Subsidiaries as of the respective
8 dates or for the respective periods set forth therein, all in conformity with United
9 States generally accepted accounting principles ("GAAP") consistently applied
during the periods involved except as otherwise noted therein, and subject, in the
case of the unaudited interim financial statements, to the absence of notes and
normal year-end adjustments that have not been and are not expected to be
material in amount. All of such America Online SEC Reports, as of their
respective dates (and as of the date of any amendment to the respective America
Online SEC Report), complied as to form in all material respects with the
applicable requirements of the Securities Act and the Exchange Act and the rules
and regulations promulgated thereunder.

10 * * *

11 (e) Information Supplied.

12 (i) None of the information supplied or to be supplied by America
13 Online for inclusion or incorporation by reference in (A) the Form S-4 (as defined
14 in Section 6.1) will, at the time the Form S-4 is filed with the SEC, at any time it
15 is amended or supplemented or at the time it becomes effective under the
16 Securities Act, contain any untrue statement of a material fact or omit to state any
17 material fact required to be stated therein or necessary to make the statements
18 therein, in light of the circumstances under which they were made, not misleading
19 and (B) the Joint Proxy Statement/Prospectus (as defined in Section 6.1) will, on
20 the date it is first mailed to Time Warner stockholders or America Online
stockholders or at the time of the Time Warner Stockholders Meeting or the
America Online Stockholders Meeting (each as defined in Section 6.1), not
contain any untrue statement of a material fact or omit to state any material fact
required to be stated therein or necessary in order to make the statements therein,
in light of the circumstances under which they were made, not misleading. The
Form S-4 and the Joint Proxy Statement/Prospectus will comply as to form in all
material respects with the requirements of the Exchange Act and the Securities
Act and the rules and regulations of the SEC thereunder.

21 291. The Joint Proxy Statement-Prospectus included the following message to
22 shareholders: "The boards of directors of both America Online and Time Warner have approved
23 the merger and recommend that their respective stockholders vote FOR the merger proposal.
24 Information about the merger is contained in this joint proxy statement-prospectus."

25 292. The Joint Proxy Statement-Prospectus continued:

26 Your vote is very important, regardless of the number of shares you own.
27 Whether or not you plan to attend the special meeting, please vote as soon as
28 possible to make sure that your shares are represented at the meeting. If you do
not vote, it will have the same effect as voting against the merger. We strongly

1 support this combination of our companies and join with our boards of directors
2 in enthusiastically recommending that you vote in favor of the merger.

3 293. The Joint Proxy Statement-Prospectus explained that the record date of eligibility
4 to vote on the Merger was May 18, 2000, and that the Special Stockholder Meetings for AOL
5 and Time Warner shareholders would both take place on June 23, 2000.

6 294. The Merger required and received the affirmative vote of the AOL and Time
7 Warner shareholders at the respective Special Stockholder Meetings.

8 295. The Merger Registration Statement and Joint Proxy Statement-Prospectus
9 included selected historical financial data of AOL, including the audited consolidated financial
10 statements of AOL for the year ended June 30, 1999 and unaudited consolidated financial
11 statements for the nine months ended March 31, 1999 and 2000.

12 296. In addition, the Merger Registration Statement and Joint Proxy Statement-
13 Prospectus included unaudited pro forma consolidated financial data of AOL Time Warner. The
14 pro forma financial results were presented on two different bases due to AOL's and Time
15 Warner's different fiscal years - a June 30 fiscal year basis and a December 31 calendar year
16 basis. The AOL Time Warner pro forma financial data included revenue data for the nine months
17 ended March 31, 2000, the year ended June 30, 1999, the three months ended March 31, 2000
18 and the year ended December 31, 1999.

19 297. The Merger Registration Statement also included the pro forma consolidated
20 condensed balance sheet of AOL Time Warner as of March 31, 2000 which purported to reflect
21 the historical financial position of AOL at March 31, 2000 and also set forth the amount
22 allocated to goodwill as a result of the Merger.

23 298. The Merger Registration Statement and Joint Proxy Statement-Prospectus also
24 incorporated by reference, *inter alia*, the documents set forth below, each of which included
25 some or all of the materially untrue and misleading financial statements and information referred
26 to herein:

27 (a) America Online's Annual Report on Form 10-K for the fiscal year ended
28 June 30, 1999 (filing date August 13, 1999);

1 (b) America Online's Quarterly Report on Form 10-Q, for the quarterly period
2 ended September 30, 1999 (filing date November 2, 1999);

3 (c) America Online's Quarterly Report on Form 10-Q, for the quarterly period
4 ended December 31, 1999 (filing date February 14, 2000);

5 (d) America Online's Quarterly Report on Form 10-Q for the quarterly period
6 ended March 31, 2000 (filing date May 17, 2000), which contains financial statements and
7 related information that restate and supersede the financial statements and related information in
8 America Online's Annual Report on Form 10-K for the fiscal year ended June 30, 1999, filed
9 August 13, 1999;

10 (e) America Online's Form 8-K dated January 19, 2000 (filing date January
11 20, 2000) incorporating AOL's press release, dated January 19, 2000, announcing AOL's
12 financial results for the quarter ended December 31, 1999;

13 (f) America Online's Current Report on Form 8-K dated January 10, 2000
14 (filing date February 11, 2000) incorporating AOL Time Warner pro forma consolidated
15 condensed financial statements for the three months ended September 30, 1999, the year ended
16 June 30, 1999, nine months ended September 30, 1999 and year ended December 31, 1998;

17 (g) America Online's Current Report on Form 8-K dated April 3, 2000 (filing
18 date April 3, 2000) incorporating AOL Time Warner pro forma consolidated condensed financial
19 statements for the six months ended December 31, 1999, the year ended June 30, 1999, and the
20 year ended December 31, 1999;

21 (h) America Online's Current Report on Form 8-K dated April 18, 2000
22 (filing date April 21, 2000) incorporating AOL's press release, dated April 18, 2000, announcing
23 AOL's financial results for the quarter ended March 31, 2000; and

24 (i) The Joint Proxy Statement-Prospectus filed with the SEC on or about May
25 19, 2000 and sent to Time Warner and AOL shareholders on or about May 23, 2000 relating to
26 the Merger of AOL and Time Warner.

1 299. The Merger Registration Statement and Joint Proxy Statement-Prospectus
2 included the January 9, 2000 opinion of Morgan Stanley to Time Warner shareholders that the
3 exchange ratio was “fair from a financial point of view” to the holders of Time Warner stock.

4 300. Ernst & Young consented to the incorporation by reference in the Merger
5 Registration Statement and Joint Proxy Statement-Prospectus of its unqualified audit report,
6 dated July 21, 1999, on AOL’s 1999 consolidated financial statements as set forth in AOL’s
7 1999 Form 10-K for the year ended June 30, 1999 and consented to all references to Ernst &
8 Young in the Merger Registration Statement and Joint Proxy Statement-Prospectus, which
9 included a reference to it under the caption “Experts.” In a subsequent amendment to the Merger
10 Registration Statement, Ernst & Young consented to the reference to itself as “Experts” and to
11 the use of its report dated July 21, 1999, except for Note 3, which is dated May 12, 2000, with
12 respect to the consolidated financial statements of AOL for the three years ended June 30, 1999
13 incorporated by reference as Exhibit 99 to AOL’s Form 10-Q/A for the quarterly period ended
14 March 31, 2000, incorporated by reference and made a part of the Merger Registration Statement
15 and Joint Proxy Statement-Prospectus. In that amendment, Ernst & Young also consented to the
16 incorporation by reference in the Merger Registration Statement and Joint Proxy Statement-
17 Prospectus, and to the reference to itself as “Experts,” of its May 19, 2000 report with respect to
18 the consolidated balance sheet of AOL Time Warner as of March 31, 2000. Finally, Ernst &
19 Young consented to the incorporation by reference in the Merger Registration Statement and
20 Joint Proxy Statement-Prospectus of its report dated July 20, 2000, with respect to the
21 consolidated financial statements of AOL included in its Form 10-K for the year ended June 30,
22 2000. These reports were incorporated in the Merger Registration Statement and Joint Proxy
23 Statement-Prospectus “in reliance on Ernst & Young’s report, given on their authority as experts
24 in accounting and auditing.”

25 301. AOL Time Warner further represented in the Merger Registration Statement and
26 Joint Proxy Statement-Prospectus that Ernst & Young had audited the consolidated balance sheet
27 of AOL Time Warner at March 31, 2000 and audited the consolidated financial statements of
28 AOL for the three years ended June 30, 1999 and that such financial statements were

1 incorporated in the Merger Registration Statement and Joint Proxy Statement-Prospectus under
2 “Experts” “in reliance on Ernst & Young LLP’s report, given on their authority as experts in
3 accounting and auditing.”

4 302. All of the financial statements of AOL contained or incorporated by reference in
5 the Merger Registration Statement and Joint Proxy Statement-Prospectus were untrue because
6 they materially overstated AOL advertising and commerce revenue, and/or AOL advertising and
7 commerce backlog, and/or percentage increases in such amounts in year over year comparisons,
8 for various fiscal periods as set forth above.

9 303. All of the pro forma financial statements for AOL Time Warner, including the
10 Company’s pro forma consolidated condensed balance sheet as of March 31, 2000, contained or
11 incorporated by reference in the Merger Registration Statement and Joint Proxy Statement-
12 Prospectus were untrue because they materially overstated AOL advertising and commerce
13 revenue, as set forth above, and because they materially overstated the real value of goodwill.

14 304. The Fairness Opinion of Morgan Stanley included or incorporated by reference in
15 the Merger Registration Statement and Joint Proxy Statement-Prospectus falsely represented that
16 the exchange ratio was “fair from a financial point of view” to Time Warner stockholders
17 because AOL stock was overvalued and AOL had engaged in sham transactions and improper
18 accounting.

19 305. All of the financial statements of AOL contained or incorporated by reference in
20 the Merger Registration Statement and Joint Proxy Statement-Prospectus falsely represented that
21 they were prepared in accordance with GAAP and Article 10 of Regulation S-X.

22 306. With respect to the audited financial statements of AOL included or incorporated
23 by reference in the Merger Registration Statement and Joint Proxy Statement-Prospectus, Ernst
24 & Young falsely represented that they were audited in conformance with GAAS.

25 307. For the same reasons set forth above, AOL’s representations and warranties in the
26 Merger Agreement attached as Annex A to the Merger Registration Statement and Joint Proxy
27 Statement-Prospectus that: (1) AOL’s financial statements were prepared in conformity with
28

GAAP; and (2) AOL's SEC filings were free of material misstatements and omissions were similarly untrue and misleading.

The Materially False and Misleading Statements and Omissions of Material Facts In AOL Time Warner's Bond Registration Statement

308. The Merger, which was finalized on January 11, 2001, was important to the new Company's credit ratings. Time Warner bonds were among the most widely-held issues, and were considered a benchmark media name in the investment-grade bond market. The Merger was expected to increase the credit ratings for both AOL and Time Warner when they became subsidiaries of AOL Time Warner.

309. Indeed, on January 14, 2001, *AFX News* reported that the new Company's credit ratings were to be raised:

Standard and Poor's Corp. said it raised its ratings on America Online, Inc. and Time Warner, Inc. to BBB+ following the completion of their merger of the two companies.

Standard and Poor's also said that all ratings have been removed from CreditWatch and the current outlook is stable.

310. Based on Defendants' representations of AOL Time Warner as "the world's preeminent Internet-powered media and communications company" with solid credit ratings and substantial revenue growth, AOL Time Warner was able to generate significant demand for the offerings of AOL Time Warner bonds.

311. In April 2002, Defendant AOL Time Warner offered and sold bonds to the public pursuant to "Amendment No. 1 to Form S-3 Registration Statement Under The Securities Act of 1933," dated February 26, 2001 ("Bond Registration Statement") and a Prospectus Supplement, dated April 3, 2002.

312. The Bond Registration Statement was signed by or on behalf of Defendants Kelly, Levin, Case, Parsons, Pittman, Novack, Akerson, Gilburne, Raines, Schuler, Ripp, Cappuccio, Barge, Pace, Caufield and Bollenbach.

313. The Bond Registration Statement incorporated by reference, *inter alia*, the documents set forth below, each of which included some or all of the materially untrue and misleading financial statements and information referenced herein:

1 (a) AOL's Annual Report on Form 10-K for fiscal year ended June 30, 2000
2 (filing date September 22, 2000), as amended by the Form 10-K/A filed October 30, 2000;

3 (b) AOL's Form 10-Q for quarter ended September 30, 2000 (filing date
4 November 9, 2000), as adjusted by AOL Time Warner's Form 8-K, dated January 18, 2001
5 (filing date January 26, 2001);

6 (c) AOL Time Warner's Joint Proxy Statement-Prospectus, included in the
7 Merger Registration Statement, which became effective May 19, 2000; and

8 (d) AOL Time Warner's Form 8-K, dated January 11, 2001 and 8-K/A dated
9 January 11, 2001 (filing dates January 12 and 26, 2001, respectively) incorporating, *inter alia*,
10 the Merger Agreement between AOL and Time Warner (Form 8-K), the AOL Time Warner
11 consolidated balance sheet as of December 31, 2000 and AOL Time Warner pro forma
12 consolidated condensed financial statements for the three months ended September 30, 2000,
13 year ended June 30, 2000, nine months ended September 30, 2000 and year ended December 31,
14 1999 (Form 8-K/A).

15 314. The Prospectus Supplement, dated April 3, 2002, also incorporated by reference
16 the same documents referenced in ¶ 313 above. In addition, this Prospectus Supplement
17 incorporated by reference AOL Time Warner's Form 10-K for the fiscal year ended December
18 31, 2001, as amended by Amendment No. 1, which included the Company's financial statements
19 for the three years ended December 31, 2001. This Form 10-K was incorporated by reference in
20 the Supplement and Bond Registration Statement under "Experts" in reliance on Ernst &
21 Young's report, given on their authority as experts in accounting and auditing.

22 315. The Bond Registration Statement and Prospectus Supplement thereto provided,
23 *inter alia*, that all documents filed by AOL Time Warner or AOL "pursuant to Section 13(a),
24 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 after the date of [this prospectus or
25 supplement] and prior to the termination of the offering of the securities, are incorporated by
26 reference into and are deemed to be a part of [this prospectus or supplement] from the date of
27 filing of those documents."
28

1 316. Financial statements audited and reported by Ernst & Young were incorporated
2 into the Bond Registration Statement and Prospectus Supplements. Specifically, Ernst & Young
3 consented to: (1) the incorporation by reference of its report dated July 20, 2000, and to the
4 reference to Ernst & Young under the caption “Experts,” with respect to AOL’s consolidated
5 financial statements included in AOL’s Form 10-K for the year ended June 30, 2000; (2) the
6 incorporation by reference of Ernst & Young’s report dated January 18, 2001 and to the
7 reference to Ernst & Young under the caption “Experts” with respect to the consolidated balance
8 sheet of AOL Time Warner as of December 31, 2000, included in AOL Time Warner’s Form 8-
9 K/A dated January 11, 2001; (3) the incorporation of Ernst & Young’s report dated January 31,
10 2001, except for Note 2 as to which the date is March 21, 2001, with respect to the consolidated
11 financial statements of AOL included in the Form 10-K for the year ended December 31, 2000
12 (which included an opinion by Ernst & Young for the period ended December 31, 1999); and (4)
13 the incorporation of Ernst & Young’s report dated January 28, 2002 with respect to the
14 consolidated financial statements of AOL Time Warner for the year ended December 31, 2001.
15 These reports were incorporated in the Bond Registration Statement “in reliance on Ernst &
16 Young’s report, given on their authority as experts in accounting and auditing.”

17 317. An amended Bond Registration Statement, filed with the SEC on February 26,
18 2001 incorporated AOL’s consolidated financial statements for the three years ended June 30,
19 2000, included in AOL’s Form 10-K for the year ended June 30, 2000, “In reliance on Ernst &
20 Young’s report, given on their authority as experts in accounting and auditing.”

21 318. All of the financial statements of AOL and AOL Time Warner contained or
22 incorporated by reference in the Bond Registration Statement and Prospectus Supplement were
23 untrue because they materially overstated AOL advertising and commerce revenue, and/or AOL
24 advertising and commerce backlog, and/or percentage increases in those amounts in year over
25 year comparisons, for various fiscal periods as set forth in ¶¶ 138-261.

26 319. All of the pro forma financial statements for AOL Time Warner contained and/or
27 incorporated in the Bond Registration Statement and Prospectus Supplement were untrue
28 because they materially overstated AOL’s and the Company’s advertising and commerce

revenue, as set forth in ¶¶ 138-261, and because they materially overstated the real value of goodwill, as set forth in ¶¶ 263-268.

320. All of the financial statements of AOL and the Company contained or incorporated by reference in the Bond Registration Statement and Prospectus Supplement falsely represented that they were prepared in accordance with GAAP and Article 10 of Regulation S-X.

321. With respect to the audited financial statements of AOL and the Company audited by Ernst & Young, which were incorporated by reference in the Bond Registration Statement and Prospectus Supplement, Ernst & Young falsely represented that they were audited in conformance with GAAS.

322. All of the financial statements of AOL and the Company included or incorporated by reference in the Bond Registration Statement and Prospectus Supplement falsely represented that they fairly represented the results of the companies' operations, particularly with respect to the advertising revenue and business of AOL.

323. For the same reasons as set forth above, AOL's representations and warranties in the Merger Agreement incorporated into the Bond Registration Statement that (1) AOL's financial statements were prepared in conformity with GAAP, and (2) AOL's SEC filings were free of material misstatements and omissions, were similarly untrue and misleading.

ERNST & YOUNG'S ROLE IN THE WRONGDOING

324. Ernst & Young was AOL's independent auditor at all times relevant to this action. Ernst & Young audited and certified AOL's financial statements for the fiscal years ended June 30, 1998, 1999 and 2000 and audited and certified AOL Time Warner's 2001 financial statements. Ernst & Young represented in AOL's fiscal 1998, 1999 and 2000 10-Ks and AOL Time Warner's 2001 10-K that the financial statements for those years fairly presented their financial condition and results of operation in conformity with GAAP and had been audited by Ernst & Young in accordance with GAAS. In fact, Ernst & Young's reports were false and misleading as AOL Time Warner's financial statements were prepared in violation of GAAP, as described above, which Ernst & Young's auditors actually knew.

1 325. AOL was a significant client for Ernst & Young's McClean, Virginia office prior
2 to the Merger. Ernst & Young's New York office audited Time Warner's financial statements
3 prior to the Merger. Later, Ernst & Young's New York office audited the combined AOL Time
4 Warner entity. The Ernst & Young partners who were responsible for this account benefited
5 financially as a result and had an interest in retaining AOL Time Warner as an accounting and
6 auditing client.

7 326. Since 1997, AOL has outsourced its internal auditing to Ernst & Young. Ernst &
8 Young received audit and other fees of \$1.3 million and \$2.2 million, respectively, in 2000 for its
9 work on AOL, and \$6.5 million and \$41.6 million, respectively in 2002 for its work on AOL
10 Time Warner. Ernst & Young received audit and other fees of \$10.6 million and \$42.1 million,
11 respectively, in 2001, for its work on AOL Time Warner. Thus, the non-audit fees were much
12 more significant than the audit fees, impairing Ernst & Young's independence.

13 327. As a result of the services rendered to AOL, Ernst & Young personnel were
14 present at AOL's corporate headquarters frequently throughout the year and had continual access
15 to and knowledge of AOL's private and confidential corporate financial and business
16 information through conversations with AOL's employees and reviewing documents not publicly
17 available.

18 328. Ernst & Young's opinion on AOL's fiscal 2000 year-end financial statements,
19 dated July 20, 2000, and included in the Company's 2000 10-K, contained the following
20 representations:

21 REPORT OF INDEPENDENT AUDITORS

22 Board of Directors and Stockholders
23 America Online, Inc.

24 We have audited the accompanying consolidated balance sheets of
25 America Online, Inc. as of June 30, 2000 and 1999, and the related consolidated
26 statements of operations, changes in stockholders' equity and cash flows for each
27 of the three years in the period ended June 30, 2000. These financial statements
28 are the responsibility of the Company's management. Our responsibility is to
 express an opinion on these financial statements based on our audits.

 We conducted our audits in accordance with auditing standards generally
 accepted in the United States. Those standards require that we plan and perform
 the audit to obtain reasonable assurance about whether the financial statements

1 are free of material misstatements. An audit includes examining, on a test basis,
2 evidence supporting the amounts and disclosures in the financial statements. An
3 audit also includes assessing the accounting principles used and significant
4 estimates made by management, as well as evaluating the overall financial
statement presentation. We believe that our audits provide a reasonable basis for
our opinion.

5 In our opinion, the financial statements referred to above present fairly, in
6 all material respects, the consolidated financial position of America Online, Inc. at
7 June 30, 2000 and 1999, and the consolidated results of its operations and its cash
flows for each of the three years in the period ended June 30, 2000, in conformity
with accounting principles generally accepted in the United States.

8 As discussed in Note 13, in 1998 the Company changed its method of
accounting for income taxes.

9 /s/ ERNST & YOUNG LLP

10 McLean, Virginia
11 July 20, 2000

12 329. Ernst & Young issued nearly identical audit reports on AOL's fiscal 1998 and
13 1999 financial statements included in the company's fiscal 1998 and 1999 Form 10-Ks.

14 330. Ernst & Young represented on January 28, 2002, as to AOL Time Warner's 2001
15 financial statements that:

16 REPORT OF INDEPENDENT AUDITORS

17 The Board of Directors
AOL Time Warner Inc.

18 We have audited the accompanying consolidated balance sheet of AOL
19 Time Warner Inc. ("AOL Time Warner") as of December 31, 2001 and 2000, and
20 the related consolidated statements of operations, shareholders' equity and cash
21 flows for each of the three years in the period ended December 31, 2001. Our
22 audits also included the financial statement schedule and supplementary
information listed in the index at Item 14 (a). These financial statements, schedule
and supplementary information are the responsibility of AOL Time Warner's
management. Our responsibility is to express an opinion on these financial
statements, schedule and supplementary information based on our audits.

23 We conducted our audits in accordance with auditing standards generally
24 accepted in the United States. Those standards require that we plan and perform
25 the audit to obtain reasonable assurance about whether the financial statements
26 are free of material misstatement. An audit includes examining, on a test basis,
27 evidence supporting the amounts and disclosures in the financial statements. An
28 audit also includes assessing the accounting principles used and significant
estimates made by management, as well as evaluating the overall financial
statement presentation. We believe that our audits provide a reasonable basis for
our opinion.

1 In our opinion, the financial statements referred to above present fairly, in
2 all material respects, the consolidated financial position of AOL Time Warner at
3 December 31, 2001 and 2000, and the consolidated results of its operations and its
4 cash flows for each of the three years in the period ended December 31, 2001, in
5 conformity with accounting principles generally accepted in the United States.
6 Also, in our opinion, the related financial statement schedule and supplementary
7 information, when considered in relation to the basic financial statements taken as
8 a whole, present fairly in all material respects the information set forth therein.

9 ERNST & YOUNG LLP

10 New York, New York
11 January 28, 2002

12 331. Ernst & Young's audit reports concerning AOL's fiscal 1998, 1999 and 2000
13 financial statements and its audit report concerning AOL Time Warner's 2001 financial
14 statements were false and misleading as those financial statements were not prepared in
15 accordance with GAAP, nor had Ernst & Young conducted its audits in accordance with GAAS.

16 332. In certifying AOL's fiscal 1998, 1999 and 2000 and AOL Time Warner's 2001
17 year-end financial statements, Ernst & Young represented that these financial statements
18 complied with GAAP. This statement was false and misleading in that Ernst & Young knew or
19 was deliberately reckless in failing to discover after conducting its audits that the financial
20 statements violated GAAP. In fact, Ernst & Young auditors knew or were deliberately reckless in
21 not knowing that revenue AOL recognized had not been earned at the time recognized or had
22 been improperly classified as revenues, as detailed above.

23 333. In certifying AOL's fiscal 1998, 1999 and 2000 and AOL Time Warner's 2001
24 year-end financial statements, Ernst & Young represented that its audits had been made in
25 accordance with GAAS.

26 334. GAAS, as approved and adopted by the American Institute of Certified Public
27 Accountants ("AICPA"), relate to the conduct of individual audit engagements. Statements on
28 Auditing Standards ("SAS") are recognized by the AICPA as the interpretation of GAAS.

335. Ernst & Young knew or was reckless in failing to discover that its audits were not
performed in accordance with GAAS in at least the following respects:

(a) Ernst & Young violated the general standard that due professional care be
exercised in the performance of the audit. An example of such violation is Ernst & Young's

1 willingness to issue a “clean” opinion notwithstanding its knowledge that the financial
2 information from which the financial statements were derived was false. Furthermore, Ernst &
3 Young did not exercise due care in its attempt to obtain competent evidential matter and
4 therefore did not obtain sufficient evidence to form the basis of the “clean” opinion issued.

5 (b) Ernst & Young violated the general standard that in all matters relating to
6 an engagement, an independence in mental attitude is to be maintained by the auditor. Ernst &
7 Young not only audited AOL’s and AOL Time Warner’s financial statements, but served as the
8 internal auditor as well. Thus, when Ernst & Young performed a year-end audit it was essentially
9 auditing its own work. Ernst & Young could not be independent in mental attitude because when
10 it found problems in AOL’s or AOL Time Warner’s books it would essentially be admitting that
11 it failed as an internal auditor. Ernst & Young is belatedly phasing out of this role in 2003.

12 (c) Ernst & Young violated the first standard of fieldwork that requires the
13 auditor to properly plan the engagement. In fact, under AU §316, consideration of fraud in a
14 financial statement audit, Ernst & Young was required to consider and plan for factors that
15 indicated AOL may be dealing with entities that were not independent. The risk factors under
16 AU §316.17 included:

- 17 • Significant, unusual, or highly complex transactions, especially those
18 close to year end, that pose difficult “substance over form” questions.
19 AOL’s reciprocal transactions posed many substance over form issues.
20 Moreover, many of the transactions were quarter-end or year-end events
21 that were not deals done in the normal course of business. The
22 Bertelsmann transaction was highly suspicious in that AOL agreed to pay
23 cash when it was not required, even though no change in the put price was
24 made. The agreement by Bertelsmann to buy \$400 million in advertising
25 was, in substance, compensation for AOL changing the terms.
- 26 • Unusually rapid growth or profitability, especially compared with that of
27 other companies in the same industry. Ernst & Young knew or recklessly
28 disregarded that AOL’s reported advertising and commerce revenues
continued to improve even as others in the industry reported disappointing
advertising revenues.

(d) Ernst & Young violated the second standard of fieldwork that requires the
auditor to make a proper study of existing internal controls, including accounting, financial and
managerial controls, to determine whether reliance on those controls was justified and, if such
controls are not reliable, to expand the nature and scope of audit procedures to be applied. A

1 federal district court judge presiding in the Homestore.com matter held that Homestore.com's
2 outside auditor ignored "red flags" with respect to transactions involving AOL -- "red flags" that
3 also should have alerted Ernst & Young to the fact that AOL's financial statements were
4 misstated:

5 Next, plaintiff details several accounting "red flags" (known as "risk factors" in
6 the GAAS, AU §§ 316.16-316.17) that PWC was confronted with and to which it
7 did not react or respond. The most significant of these red flags was the fact that
8 on numerous occasions, major transactions took place within the last few days of
9 the quarter....

10 ... First and foremost, one of the principal issues in the late 1990s was how to
11 properly account for "barter-type" transactions. In January 2000, at the beginning
12 of the class period, the Financial Accounting Standards Board made effective
13 "Emerging Issues Task Force ("EITF") Issue No. 99-17," entitled "Accounting
14 for Advertising Barter Transactions." FACC ¶ 545. Such transactions could only
15 be recorded if the fair value of the advertising surrendered in the transaction could
16 be determined based on the company's own historical practices of receiving cash
17 or cash equivalents for similar advertising sold to unrelated entities. FACC ¶ 546.
18 Similarly, EITF 99-19, also effective prior to the class period, dealt with
19 recognition of gross revenues versus net. FACC ¶ 550-551. Many of Homestore's
20 reciprocal "barter-type" transactions were alleged to have violated both of these
21 rules.

22 *In re Homestore.com, Inc. Sec. Litig.*, No. C-01-11115-MJP(CWx), 2003 U.S. Dist. LEXIS
23 3499, at *70-*71 (C.D. Cal. Mar. 7, 2003).

24 (e) Ernst & Young violated the third standard of fieldwork that requires the
25 auditor to obtain sufficient competent evidential matter through inspection, observation, inquiries
26 and confirmations to afford a reasonable basis for an opinion regarding the financial statements
27 under audit.

28 (f) Ernst & Young violated the fourth standard of reporting that requires that
29 when an opinion on the financial statements as a whole can not be expressed, the reasons
30 therefor must be stated. In view of the aforementioned GAAS and GAAP violations, Ernst &
31 Young should have stated that it could express no opinion as to the financial statements of AOL
32 or should have issued an adverse opinion stating that AOL's fiscal 1998, 1999 and 2000 and
33 AOL Time Warner's 2001 financial statements were not presented fairly and in accordance with
34 GAAP.

1 336. In the course of issuing its unqualified audit opinion as to AOL's fiscal 1998,
2 1999 and 2000 and AOL Time Warner's 2001 financial statements, Ernst & Young knew that it
3 was required to adhere to all of the standards and principles of GAAS, including the requirement
4 that the financial statements comply in all material respects with GAAP. In issuing its
5 unqualified opinions for AOL's financial results, Ernst & Young knew or was deliberately
6 reckless in not knowing that its audits and reports were not in compliance with GAAS and that
7 AOL's financial results were not reported in accordance with GAAP.

8 **MORGAN STANLEY'S AND SALOMON SMITH BARNEY'S**
9 **ROLES IN THE WRONGDOING**

10 337. In corporate mergers where shareholder approval of the transaction is necessary, a
11 "fairness opinion" from a reputable, sophisticated and independent investment banking firm is
12 indispensable to the completion of the transaction. Indeed, it is unlikely that the AOL Time
13 Warner Merger could have been consummated in the absence of such opinions.

14 338. Because of the nature of the AOL Time Warner Merger and because of the size
15 and market capitalization of the companies involved, it was necessary that the transaction be
16 structured as a stock-for-stock exchange rather than a cash acquisition, as neither company had
17 sufficient cash resources to acquire the other for cash. Stock-for-stock merger transactions
18 without a collar - as was the case here - are extremely complex and fragile, especially where the
19 so-called exchange ratio of the stock to be exchanged in the merger is fixed, as was the case in
20 the AOL Time Warner Merger. This is because if the business, and therefore the stock price, of
21 one of the companies to the transaction declines materially, the shareholders of the other
22 company may perceive that the merger is no longer fair to them. If the decline were significant
23 enough, the directors of the enterprise being acquired would have to invoke the "material adverse
24 change" provisions contained in the merger agreement to scuttle the deal.

25 339. In the AOL Time Warner Merger, Morgan Stanley and Salomon Smith Barney
26 each played indispensable roles in disseminating false and misleading information to investors
27 and the market regarding the quality, strength and growth of AOL's business, as well as the
28 quality, strength and growth prospects of the company to be created by the Merger, and most

1 importantly, the fairness of the terms of the Merger to the Time Warner shareholders, all of
2 which was significantly relied upon, directly or indirectly, by Plaintiff in this action in
3 exchanging its Time Warner shares for shares of AOL Time Warner in the Merger, in voting to
4 approve the sale of Time Warner to AOL via merger (or failing to approve said Merger) and in
5 purchasing AOL Time Warner stock in the open market subsequent to the Merger.

6 340. The structure of the fees to be paid to Salomon Smith Barney and Morgan Stanley
7 highly incentivized them to take whatever steps were necessary to bring about completion of the
8 Merger by inflating the price of AOL's stock in advance of the Merger, by helping to
9 disseminate false and misleading information regarding the strength, quality and growth of
10 AOL's business, by securing the approval of the Time Warner shareholders to the Merger and by
11 supporting the price of AOL Time Warner stock after the Merger so as to continue the illusion of
12 the success of the Merger while the AOL Time Warner insiders bailed out by selling off millions
13 of shares of their new AOL Time Warner stock at artificially inflated levels. Part of the
14 incentives for the financial advisors to do this included the manner in which their compensation
15 was structured whereby they received only a small part of their potential total compensation
16 (\$135 million) when the Merger agreement was signed, but received the vast bulk of their
17 compensation upon and after shareholder approval of the transaction and on the actual closing of
18 the Merger. And, in the case of Morgan Stanley, additional bonus compensation worth \$15
19 million if the new AOL Time Warner stock traded at high levels in the few weeks following the
20 consummation of the Merger - which it did. Thus, the compensation arrangements for the
21 financial advisors incentivized them to do everything necessary to inflate the price of AOL stock
22 prior to the Merger, obtain Time Warner shareholder approval of the Merger, get the Merger
23 closed, and keep the AOL Time Warner stock trading at as high a price level as possible for as
24 long as they could after the Merger was closed. Thus the financial advisors had an enormous
25 financial interest in bringing about shareholder approval of the Merger and closing the Merger,
26 but little, if any, interest in how the business of the new entity, AOL Time Warner, performed in
27 the long-term after the Merger was closed.

1 341. In the period after the Merger was announced, and up to and including the
2 shareholder approval of the Merger, Salomon Smith Barney and Morgan Stanley each issued
3 false and misleading research reports about AOL, Time Warner and AOL Time Warner that
4 helped to artificially inflate the price of AOL stock and make AOL appear to be a more
5 successful company than it really was. And Morgan Stanley issued the critical “fairness opinion”
6 contained in the Merger Registration Statement which represented that the terms of the Merger
7 were fair from a financial point of view to Time Warner shareholders when they knew, or should
8 have known, that this opinion was false and they had no reasonable grounds for believing that
9 the transaction was, in fact, fair. After the shareholder vote approving the deal and up through
10 and including the closing of the Merger, it continued to be very important to make it appear that
11 AOL’s business was continuing to achieve strong success and growth and that the enterprise to
12 be formed as a result of the Merger of AOL and Time Warner would continue to achieve huge
13 revenue, EBITDA and free cash flow growth. Salomon Smith Barney and Morgan Stanley
14 continued to feed false and misleading reports to the market in this regard.

15 342. After the Merger closed, Morgan Stanley and Salomon Smith Barney continued to
16 help perpetuate the illusion of the success of the Merger and the strength and growth being
17 achieved by AOL Time Warner by continuously issuing false and misleading research reports,
18 some of which were detailed above.

19 343. On and after the closing of the Merger, Morgan Stanley and Salomon Smith
20 Barney were constantly buying and selling AOL Time Warner stock in their own proprietary
21 trading accounts as well as accounts they managed for other entities and investors.

22 344. One of the reasons that Salomon Smith Barney and Morgan Stanley were willing
23 to participate in this wrongful course of conduct and issue the false and misleading opinions and
24 reports as alleged, was that they had taken steps to attempt to insulate themselves from the
25 consequences of such misconduct by requiring that AOL, Time Warner and AOL Time Warner
26 indemnify them and hold them harmless from any financial impact (including legal fees) from
27 any alleged or proven violation of the securities laws in connection with the Merger transaction.
28 Because of the size of and assets of AOL, Time Warner and AOL Time Warner and the fact that

each of the companies carried very substantial directors' and officers' liability insurance running into the hundreds of millions of dollars, Salomon Smith Barney and Morgan Stanley knew that it was essentially risk-free financially for them to participate in and further the wrongdoing while pocketing fees - the largest investment banking fees in history - of \$135 million. Thus, Salomon Smith Barney and Morgan Stanley lent their considerable expertise and reputations to the successful consummation of the Merger which created AOL Time Warner, and enriched the corporate executives who hired them by well over \$1 billion, permitting Salomon Smith Barney and Morgan Stanley to pocket millions in fees for themselves.

THE AOL TIME WARNER INSIDERS' MASSIVE SALES

345. During July and August 2000, when AOL stock was artificially inflated in anticipation of the Merger of AOL and Time Warner, as set forth earlier, top AOL insiders sold off some 2.8 million shares of their AOL stock at as high as \$60.44 per share, pocketing almost \$158 million. This insider selling is shown below:

	SHARES SOLD BETWEEN <u>07/14/00-08/30/00</u>	<u>PROCEEDS</u>
<u>INSIDER</u>		
Akerson	24,082	\$ 1,431,049
Barksdale	700,000	\$ 38,095,100
Case	1,000,000	\$ 56,367,000
Caufield	100,000	\$ 6,044,000
Gilburne	237,651	\$ 13,313,376
Kelly	70,000	\$ 3,999,800
Novack	96,634	\$ 5,412,772
Pittman	394,745	\$ 21,833,346
Vradenburg	<u>200,000</u>	<u>\$ 11,336,000</u>
TOTALS:	2,823,112	\$157,832,442

Then, after the Merger and prior to the final revelations of early February 2003, AOL Time Warner insiders unloaded over 24 million shares of their AOL Time Warner common stock, pocketing almost \$780 million in insider trading proceeds. This insider selling is shown below:

	SHARES SOLD BETWEEN <u>01/01/01-11/30/02</u>	<u>PROCEEDS</u>
<u>INSIDER</u>		
Akerson	143,918	\$ 7,078,357
Barge	121,500	\$ 1,493,368
Barksdale	2,492,550	\$ 81,281,309
Case	2,000,000	\$ 100,396,300
Caufield	50,000	\$ 2,573,500
Colburn	180,000	\$ 9,060,600

Gilburne	400,000	\$ 19,750,610
Kelly	400,000	\$ 19,072,000
Lerer	200,000	\$ 10,526,000
Novack	744,366	\$ 34,731,161
Parsons	700,000	\$ 35,267,400
Pittman	1,500,000	\$ 72,715,000
Raduchel	44,444	\$ 2,125,312
Stuntz	450,000	\$ 22,788,000
Turner	14,648,252	\$ 332,000,653
Vradenburg	566,402	\$ 28,157,000
TOTALS:	24,641,432	\$ 779,016,571

Thus, while AOL's and AOL Time Warner's stocks were artificially inflated in anticipation of and in consequence of the Merger, AOL and AOL Time Warner insiders unloaded a total of 27.5 million shares, pocketing \$937 million of illegal insider trading proceeds.

FIRST CAUSE OF ACTION

For Violation of §11 of the 1933 Act Against AOL Time Warner and Those AOL and Time Warner Directors or Officers Who Signed the Merger Registration Statement, and Ernst & Young

346. Plaintiff incorporates ¶¶ 1 - 345 except allegations of fraud, scienter or intentional misconduct.

347. This cause of action is brought against Defendants AOL Time Warner, Ernst & Young, Case, Levin, Parsons, Turner, Novack, Pittman, Kelly, Akerson, Barksdale, Bollenbach, Caufield, Gilburne, Hills, Mark, Miles, Raines, Vincent, and Cappuccio for violation of §11 of the 1933 Act.

348. Plaintiff asserts only strict liability and negligence claims in this First Cause of Action. Plaintiff does not assert claims of fraud or intentional misconduct.

349. On February 11, 2000, AOL and Time Warner and their respective officers, directors, financial advisors and Ernst & Young filed the first draft of the Merger Registration Statement with the SEC to issue and register the new AOL Time Warner shares to be sold in an initial public offering of their shares in the Merger.

350. On May 19, 2000, the Merger Registration Statement for the new shares of AOL Time Warner stock to be issued in connection with the Merger became effective with the SEC. The offering and sale of AOL Time Warner stock pursuant to the Merger Registration Statement

1 was an initial public offering of AOL Time Warner's stock, which stock had never before
2 existed, been issued or been publicly traded. Therefore, the "safe harbor" under the 1933 Act
3 does not apply to statements made in the Merger Registration Statement.

4 351. All of the AOL Time Warner shares of stock issued in the Merger were issued
5 pursuant to Merger Registration Statement which was false and misleading for the reasons set
6 forth above at ¶¶ 302-307.

7 352. The Individual Defendants named herein were officers or directors of AOL Time
8 Warner who each signed the Merger Registration Statement. AOL Time Warner was the issuer
9 of those shares issued and sold via the Merger.

10 353. Ernst & Young consented to the inclusion of its opinions on AOL's 1998, 1999
11 and 2000 financial statements in the Merger Registration Statement and reviewed and approved
12 the interim unaudited financial results included in the Merger Registration Statement.

13 354. AOL Time Warner is strictly liable for the false Merger Registration Statement.
14 Each of the Defendants named in this cause of action owed to the acquirers of the AOL Time
15 Warner stock issued in the Merger the duty to make a reasonable and diligent investigation of the
16 statements contained in the Merger Registration Statement at the time it became effective, to
17 ensure that they were true and that there was no omission to state a material fact required to be
18 stated in order to make the statements contained therein not misleading. In the exercise of
19 reasonable care, these Defendants knew or should have known of the material misstatements and
20 omissions contained in the Merger Registration Statement.

21 355. None of the Defendants named in this cause of action made a reasonable
22 investigation or possessed reasonable grounds for the belief that the statements contained in the
23 Merger Registration Statement were true and did not omit any material facts and were not
24 misleading.

25 356. The Defendants caused to be issued and participated in the issuance of the
26 materially false and misleading statements in the Merger Registration Statement, which
27 misrepresented or failed to disclose, *inter alia*, the adverse facts set forth above. Thus,
28 defendants violated §11 of the 1933 Act.

357. Plaintiff acquired AOL Time Warner stock in the Merger pursuant to the false and misleading Merger Registration Statement without knowledge of the untruths or omissions alleged herein. Plaintiff could not have reasonably discovered the nature of these untruths and omissions, and relied either directly or indirectly on the false and misleading Merger Registration Statement in acquiring of AOL Time Warner stock.

358. As a result of its purchases of AOL Time Warner stock issued pursuant to the false Merger Registration Statement, Plaintiff has suffered damages.

SECOND CAUSE OF ACTION

**For Violation of §11 of the 1933 Act Against
AOL Time Warner and Those AOL and Time Warner Directors or Officers
Who Signed the Stock Option Registration Statements, and Ernst & Young**

359. Plaintiff incorporates ¶¶ 1 - 358 except allegations of fraud, scienter or intentional misconduct.

360. This cause of action is brought against Defendants AOL Time Warner, Ernst & Young, Case, Levin, Parsons, Turner, Novack, Pittman, Kelly, Akerson, Barksdale, Bollenbach, Caufield, Gilburne, Hills, Mark, Miles, Raines, and Vincent for violation of §11 of the 1933 Act.

361. Plaintiff asserts only strict liability and negligence claims in this Second Cause of Action. Plaintiff does not assert claims of fraud or intentional misconduct.

362. In connection with the AOL Time Warner Merger, all the shares of AOL Time Warner necessary to cover the previously granted stock options of AOL and Time Warner to their employees were registered with the SEC pursuant to a series of registration statements (the “Stock Option Registration Statements”) filed and effective on January 11, 2001 and signed by each of the directors of AOL and Time Warner named as Defendants. The Merger Registration Statement stated:

AOL Time Warner will file a registration statement covering the issuance of the shares of AOL Time Warner common stock subject to each America Online and Time Warner option and restricted shares and will maintain the effectiveness of that registration statement for as long as any of the options or restricted shares remain outstanding.

1 363. The Stock Option Registration Statements, which became effective with the SEC
2 on January 11, 2001, each incorporated the following documents by reference, which documents
3 were false and misleading for the reasons stated above:

- 4 • America Online, Inc.'s Annual Report on Form 10-K for the fiscal year
5 ended June 30, 2000 (filing date September 22, 2000), as amended by
6 Amendment No. 1 thereto on Form 10-K/A dated October 27, 2000 (filing
7 date October 30, 2000).
- 8 • America Online, Inc.'s Quarterly Report on Form 10-Q for the quarterly
9 period ended September 30, 2000 (filing date November 9, 2000).

10 364. Thus, all the AOL Time Warner shares of stock trading in the open market
11 subsequent to the Merger entered the market pursuant to either the Merger or to the option
12 exercise or sale and were thus issued pursuant to either the false and misleading Merger
13 Registration Statement or the false and misleading Stock Option Registration Statements. The
14 Stock Option Registration Statements and the statements made therein were issued and made in
15 connection with the initial public offering of AOL Time Warner's stock. Therefore, the "safe
16 harbor" under the 1933 Act does not apply to statements made in the Stock Option Registration
17 Statements.

18 365. The Individual Defendants named herein were officers or directors of AOL Time
19 Warner who each signed the Stock Option Registration Statements. AOL Time Warner was the
20 issuer of those shares issued and sold via the Stock Option Registration Statements.

21 366. Ernst & Young consented to the inclusion of its opinions on AOL's 1998, 1999
22 and 2000 financial statements in the Stock Option Registration Statements and reviewed and
23 approved the interim unaudited financial results included in the Stock Option Registration
24 Statements.

25 367. AOL Time Warner is strictly liable for the false Stock Option Registration
26 Statements. Each of the Defendants named in this cause of action owed to the purchasers of the
27 AOL Time Warner stock, including Plaintiff, the duty to make a reasonable and diligent
28 investigation of the statements contained in the Stock Option Registration Statements at the time
they became effective, to ensure that they were true and that there was no omission to state a
material fact required to be stated in order to make the statements contained therein not

misleading. In the exercise of reasonable care, these Defendants knew or should have known of the material misstatements and omissions contained in the Stock Option Registration Statements.

368. None of the Defendants named in this cause of action made a reasonable investigation or possessed reasonable grounds for the belief that the statements contained in the Stock Option Registration Statements were true and did not omit any material facts and were not misleading.

369. The Defendants caused to be issued and participated in the issuance of the materially false and misleading statements in the Stock Option Registration Statements, which misrepresented or failed to disclose, *inter alia*, the adverse facts set forth above. Thus, defendants violated §11 of the 1933 Act.

370. Plaintiff purchased AOL Time Warner stock traceable to the false and misleading Merger Registration Statement and/or Stock Option Registration Statements without knowledge of the untruths or omissions alleged herein. Plaintiff could not have reasonably discovered the nature of these untruths and omissions, and relied either directly or indirectly on the false and misleading Merger Registration Statement and Stock Option Registration Statements in making its purchases of AOL Time Warner stock.

371. As a result of its purchases of AOL Time Warner stock issued pursuant to the false Stock Option Registration Statements, plaintiff has suffered damages.

THIRD CAUSE OF ACTION

For Violation of §11 of the 1933 Act Against Defendant AOL Time Warner and Those AOL and Time Warner Directors or Officers Who Signed the Bond Registration Statement, the Underwriter Defendants and Ernst & Young

372. Plaintiff incorporates ¶¶ 1 - 371 except allegations of fraud, scienter or intentional misconduct.

373. This cause of action is brought against Defendants AOL Time Warner, Kelly, Levin, Case, Parsons, Pittman, Novack, Akerson, Gilburne, Raines, Schuler, Ripp, Cappucio, Barge, Pace, Caufield, Bollenbach, Morgan Stanley, Salomon, Citigroup, Banc of America, J. P. Morgan, and Ernst & Young for violation of §11 of the 1933 Act.

1 374. Plaintiff asserts only strict liability and negligence claims in this Third Cause of
2 Action. Plaintiff does not assert claims of fraud or intentional misconduct.

3 375. In April 2002, Defendant AOL Time Warner offered and sold bonds to the public
4 pursuant to the Bond Registration Statement and a Prospectus Supplement, dated April 3, 2002.

5 376. The Bond Registration Statement was signed by or on behalf of Defendants Kelly,
6 Levin, Case, Parsons, Pittman, Novack, Akerson, Gilburne, Raines, Schuler, Ripp, Cappuccio,
7 Barge, Pace, Caufield and Bollenbach.

8 377. The Bond Registration Statement incorporated by reference, *inter alia*, each of the
9 documents set forth in ¶¶ 313-314 above which were false and misleading for the reasons
10 detailed in ¶¶ 318-323.

11 378. The Individual Defendants named herein were officers or directors of AOL Time
12 Warner who each signed the Bond Registration Statement. AOL Time Warner was the issuer of
13 the bonds.

14 379. Ernst & Young consented to the inclusion of its opinions on AOL's financial
15 statements in the Bond Registration Statement and reviewed and approved the interim unaudited
16 financial results included in the Bond Registration Statement and Prospectus Supplement.

17 380. The Underwriter Defendants were the underwriters on the Bond Offering.

18 381. AOL Time Warner is strictly liable for the false Bond Registration Statement.
19 Each of the Defendants named in this cause of action owed to the acquirers of AOL Time
20 Warner bonds the duty to make a reasonable and diligent investigation of the statements
21 contained in the Bond Registration Statement at the time it became effective, to ensure that they
22 were true and that there was no omission to state a material fact required to be stated in order to
23 make the statements contained therein not misleading. In the exercise of reasonable care, these
24 Defendants knew or should have known of the material misstatements and omissions contained
25 in the Bond Registration Statement.

26 382. None of the Defendants named in this cause of action made a reasonable
27 investigation or possessed reasonable grounds for the belief that the statements contained in the
28

Bond Registration Statement were true and did not omit any material facts and were not misleading.

383. The Defendants caused to be issued and participated in the issuance of the materially false and misleading statements in the Bond Registration Statement, which misrepresented or failed to disclose, *inter alia*, the adverse facts set forth above. Thus, defendants violated §11 of the 1933 Act.

384. Plaintiff acquired AOL Time Warner bonds pursuant to the false and misleading Bond Registration Statement without knowledge of the untruths or omissions alleged herein. Plaintiff could not have reasonably discovered the nature of these untruths and omissions, and relied either directly or indirectly on the false and misleading Bond Registration Statement in acquiring AOL Time Warner bonds.

385. As a result of its purchases of AOL Time Warner bonds issued pursuant to the false Bond Registration Statement, Plaintiff has suffered damages.

FOURTH CAUSE OF ACTION

For Violation of §12(a)(2) of the 1933 Act Against Defendant AOL Time Warner With Respect to the Merger Registration Statement

386. Plaintiff incorporates ¶¶ 1 - 385 except allegations of fraud, scienter or intentional misconduct.

387. On February 11, 2000, AOL and Time Warner and AOL Time Warner filed the initial draft registration statement for the shares to be sold and issued in the Merger. From and after this date, AOL, Time Warner and AOL Time Warner were “in registration” and all their (and their agents, Salomon Smith Barney’s and Morgan Stanley’s) subsequent written and oral statements pertaining to the Merger prior to the June 23, 2000 shareholder votes approving the Merger give rise to §11 and §12(a)(2) 1933 Act liability under SEC regulations.

388. The Merger Registration Statement contained untrue statements of material fact, and concealed and failed to disclose material facts, as detailed above. AOL Time Warner owed plaintiff the duty to make a reasonable and diligent investigation of the statements contained in the Merger Registration Statement to ensure that such statements were true and that there was no

1 omission to state a material fact required to be stated in order to make the statements contained
2 therein not misleading. AOL Time Warner, in the exercise of reasonable care, should have
3 known of the misstatements and omissions contained in the Merger Registration Statement as set
4 forth above.

5 389. AOL Time Warner did not make a reasonable investigation or possess reasonable
6 grounds for the belief that the statements contained in the Merger Registration Statement were
7 true and did not omit any material facts and were not misleading.

8 390. Plaintiff did not know, nor in the exercise of reasonable diligence could it have
9 known, of the untruths and omissions contained in the Merger Registration Statement at the time
10 it acquired AOL Time Warner stock.

11 391. By reason of the conduct alleged herein, AOL Time Warner violated §12(a)(2) of
12 the 1933 Act. As a direct and proximate result of such violations, plaintiff sustained substantial
13 damages in connection with its purchases of AOL Time Warner stock in the Merger.

14 **FIFTH CAUSE OF ACTION**

15 **For Violation of §12(a)(2) of the 1933 Act** 16 **Against the Underwriter Defendants** 17 **With Respect to the Bond Registration Statement**

18 392. Plaintiff incorporates ¶¶ 1 - 391 except allegations of fraud, scienter or intentional
19 misconduct.

20 393. The Bond Registration Statement contained untrue statements of material fact,
21 and concealed and failed to disclose material facts, as detailed above.

22 394. The Underwriter Defendants, as underwriters in a firm commitment underwriting,
23 are statutory sellers under §12(a)(2) of the Securities Act.

24 395. The Underwriter Defendants owed Plaintiff the duty to make a reasonable and
25 diligent investigation of the statements contained in the Bond Registration Statement to ensure
26 that such statements were true and that there was no omission to state a material fact required to
27 be stated in order to make the statements contained therein not misleading. The Underwriter
28

Defendants, in the exercise of reasonable care, should have known of the misstatements and omissions contained in the Bond Registration Statement as set forth above.

396. The Underwriter Defendants did not make a reasonable investigation or possess reasonable grounds for the belief that the statements contained in the Bond Registration Statement were true and did not omit any material facts and were not misleading.

397. Plaintiff did not know, nor in the exercise of reasonable diligence could it have known, of the untruths and omissions contained in the Bond Registration Statement at the time it acquired AOL Time Warner bonds.

398. By reason of the conduct alleged herein, the Underwriter Defendants violated §12(a)(2) of the 1933 Act. As a direct and proximate result of such violations, plaintiff sustained substantial damages in connection with its purchases of AOL Time Warner bonds.

SIXTH CAUSE OF ACTION

**For Violation of Cal. Corp. Code
§25400, *et seq.* and §25500, *et seq.*
Against Defendants AOL Time Warner, Ernst & Young,
the Underwriter Defendants and the
Individual Defendants Who Sold Stock**

399. Plaintiff incorporates ¶¶ 1 - 398.

400. This cause of action is brought pursuant to Cal. Corp. Code §§ 25400-25403, 25500- 25502, 25502.5, 25504, 25504.1 and 25504.2 against Defendants AOL Time Warner, Ernst & Young, Morgan Stanley, Salomon Smith Barney, Citigroup, Banc of America, J.P. Morgan, Akerson, Barge, Barksdale, Case, Caufield, Colburn, Gilburne, Kelly, Lerer, Novack, Parsons, Pittman, Raduchel, Stuntz, Turner and Vradenburg. Defendants offered for sale and sold AOL Time Warner securities via the false and misleading Merger Registration Statement, Bond Registration Statement, and Stock Option Registration Statements, as well as the other false and misleading written and oral statements alleged.

401. The Merger Registration Statement, Bond Registration Statement, and Stock Option Registration Statements contained untrue statements of material facts and omitted to state material facts required to be stated therein or necessary to make the statements made in the

1 Merger Registration Statement, Bond Registration Statement, and Stock Option Registration
2 Statements not misleading.

3 402. Defendant AOL Time Warner and individual defendants Akerson, Barge,
4 Barksdale, Case, Caufield, Colburn, Gilburne, Kelly, Lerer, Novack, Parsons, Pittman, Raduchel,
5 Stuntz, Turner and Vradenburg, sold or offered for sale AOL Time Warner securities during the
6 time period plaintiff was purchasing its AOL Time Warner securities.

7 403. During the time period that plaintiff purchased its AOL Time Warner securities,
8 defendant AOL Time Warner was constantly selling or offering for sale AOL Time Warner
9 securities both in the Merger and also continuously thereafter via the AOL Time Warner stock
10 option plans by which millions of shares of stock were sold or offered for sale by AOL Time
11 Warner to AOL Time Warner executives and employees. During 2001, AOL Time Warner
12 issued and sold 108,860,000 shares of its common stock pursuant to the AOL Time Warner stock
13 options plans. AOL Time Warner had a motive and incentive to inflate the price of its common
14 stock to induce the exercise of stock options by AOL Time Warner employees, as the exercise of
15 such stock options generated millions of dollars of new capital for AOL Time Warner. AOL
16 Time Warner also sold bonds pursuant to the April 2002 Bond Offering.

17 404. Individual Defendants Akerson, Barge, Barksdale, Case, Caufield, Colburn,
18 Gilburne, Kelly, Lerer, Novack, Parsons, Pittman, Raduchel, Stuntz, Turner and Vradenburg all
19 engaged in the sale of AOL and AOL Time Warner stock as specified herein. These Individual
20 Defendants had a motive and an economic interest in inflating the price of AOL and AOL Time
21 Warner securities because the higher the price of AOL and AOL Time Warner stock, the more
22 money they received upon the sale of their stock.

23 405. On and after the closing of the Merger, Morgan Stanley and Salomon Smith
24 Barney were constantly buying and selling AOL Time Warner securities in their own proprietary
25 trading accounts as well as accounts they managed for other entities and investors. Moreover, all
26 of the Underwriter Defendants sold or offered for sale AOL Time Warner bonds as part of and
27 subsequent to the April 2002 Bond Offering.

1 406. Ernst & Young knowingly provided substantial assistance to the other Defendants
2 named in this cause of action in violation of Cal. Corp. Code §25403(b) and is deemed to be in
3 violation to the same extent as the other Defendants named in this cause of action.

4 407. For the purpose of inducing the purchase of AOL Time Warner securities by
5 others, each of the Defendants named in this cause of action made statements which were, at the
6 time and in light of the circumstances under which they were made, false and misleading with
7 respect to material facts or which omitted to state material facts necessary in order to make the
8 statements made, in the light of the circumstances under which they were made, not misleading.
9 Each such Defendant knew or had reasonable grounds to believe that the statements made by
10 them were false or misleading.

11 408. Each of the Individual Defendants named in this cause of action participated in
12 the day-to-day management and supervision of AOL Time Warner throughout the relevant time
13 period or had a special relationship with the Company that gave them access to material non-
14 public information, knowledge that public statements being made were false and misleading and
15 had the ability to prevent those false and misleading statements from being made or to correct
16 them.

17 409. In addition, each of the Defendants knowingly and willfully participated in or
18 materially aided and abetted the preparation, issuance and circulation of the Merger Registration
19 Statement, Bond Registration Statement, and Stock Option Registration Statements with
20 knowledge of or in reckless disregard for their falsity and the intent to cause Plaintiff, its agents
21 and others to rely thereon.

22 410. AOL Time Warner, especially through its Time Warner division, has very
23 substantial operations in California. Many thousands of shares of AOL Time Warner stock were
24 sold or offered for sale to AOL Time Warner employees located in California. All Defendants'
25 false and misleading statements were intended to and did enter into and were disseminated in
26 California by way of the nationwide release of press releases, nationwide telephone conference
27 calls and interviews which the participating Defendants knew or should have known would be
28 disseminated on a national if not worldwide basis.

411. At the time Plaintiff purchased AOL Time Warner securities, it did not know of any of the alleged false and/or misleading statements and omissions.

412. As a result, Defendants' violations of the provisions of the Cal. Corp. Code as alleged herein, including these materially false and misleading statements, proximately damaged plaintiff in its purchases of AOL Time Warner securities.

SEVENTH CAUSE OF ACTION

**For Common Law Fraud (Cal. Civ. Code §§1572-1573 and
1709-1710 and Cal. Corp. Code §1507)
Against All Defendants**

413. Plaintiff incorporates ¶¶ 1 - 412.

414. This cause of action is brought against all Defendants based on common law principles of fraud and deceit, scheme, aiding and abetting, conspiracy and fraudulent course of business.

415. As alleged herein, Defendants each made or participated in making material misrepresentations, or omitted to disclose material facts, to Plaintiff, its agents, and the investing public regarding AOL and AOL Time Warner. Each of the Defendants knowingly participated in the making, issuance and publication of prospectuses, financial statements and other documents respecting AOL's, Time Warner's and AOL Time Warner's assets, business, and earnings, which were false in material respects.

416. Defendants each participated in the fraud and deceit by way of conspiracy to commit these wrongs, by materially aiding and abetting the same and/or by participating in a scheme to defraud Plaintiff or its agents, regarding AOL Time Warner and AOL Time Warner's financial condition, and each committed overt acts, including the making of false and misleading statements, in furtherance of such scheme, conspiracy or fraudulent course of conduct.

417. Defendants' misrepresentations and omissions were made intentionally or recklessly or with no reasonable ground for believing them to be true, to induce reliance thereon by Plaintiff and its agents, and the investing public when making investment decisions.

418. The aforesaid misrepresentations and omissions by Defendants constitute fraud and deceit.

419. Plaintiff and/or its agents reasonably relied on Defendants' representations and statements when deciding to approve the sale of Time Warner to AOL, *i.e.*, the Merger, and to purchase AOL Time Warner securities in the Merger and thereafter.

420. At the time the Merger was approved and/or its AOL Time Warner securities were purchased, neither Plaintiff nor its agents knew of any of the false and/or misleading statements and omissions.

421. As a direct and proximate result of the fraud and deceit of Defendants, Plaintiff suffered damages in connection with its purchases of AOL Time Warner securities.

EIGHTH CAUSE OF ACTION

**For Inducement to Retain AOL Time Warner Securities
(Pursuant to Cal. Civ. Code §§1572-1573 and 1709-1710
and Cal. Corp. Code §1507) Against All Defendants**

422. Plaintiff incorporates ¶¶ 1 - 421.

423. This cause of action is brought against all Defendants based on common law principles of fraud and, specifically, fraudulent inducement to retain AOL Time Warner securities.

424. As alleged herein, Defendants each made or participated in making material misrepresentations, or omitted to disclose material facts, to Plaintiff, its agents, and the investing public regarding AOL and AOL Time Warner. Each of the Defendants knowingly participated in the making, issuance and publication of prospectuses, financial statements and other documents respecting AOL's, Time Warner's and AOL Time Warner's assets, business, and earnings, which were false in material respects.

425. Defendants each participated in the fraud and deceit by way of conspiracy to commit these wrongs, by materially aiding and abetting the same and/or by participating in a scheme to defraud Plaintiff or its agents, regarding AOL Time Warner and AOL Time Warner's financial condition, and each committed overt acts, including the making of false and misleading statements, in furtherance of such scheme, conspiracy or fraudulent course of conduct.

426. Defendants' misrepresentations and omissions were made intentionally or recklessly or with no reasonable ground for believing them to be true, to induce reliance thereon by Plaintiff and its agents, and the investing public when making investment decisions.

427. The aforesaid misrepresentations and omissions by Defendants constitute fraud and deceit.

428. Plaintiff and/or its agents reasonably relied on Defendants' representations and statements in deciding not to sell its AOL Time Warner securities when the internet business was otherwise experiencing a downturn but Defendants represented that AOL Time Warner was immune from such downturn due to its strong advertising revenues.

429. At the time that Plaintiff and/or its agents decided to retain its AOL Time Warner securities, neither Plaintiff nor its agents knew of any of the false and/or misleading statements and omissions.

430. As a direct and proximate result of the fraud and deceit of Defendants, Plaintiff suffered damages in connection with their retention of AOL Time Warner securities.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff prays for judgment as follows:

A. Awarding preliminary and permanent injunctive relief in favor of Plaintiff against Defendants and their counsel, agents and all persons acting under, in concert with, or for them, including an accounting of and the imposition of a constructive trust and/or an asset freeze on Defendants' insider trading proceeds;

B. Ordering an accounting of Defendants' insider-trading proceeds:

C. Ordering disgorgement of Defendants' insider-trading proceeds;

D. Awarding restitution to Plaintiff of any monies of which it was defrauded;

E. Awarding compensatory damages in favor of Plaintiff against all Defendants, jointly and severally, for all damages sustained as a result of Defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

F. Awarding rescission or a rescissory measure of damages;

G. Awarding Plaintiff its reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

H. Such other and further relief as the Court may deem just and proper.

JURY DEMAND

Plaintiff demands a trial by jury.

DATED: July 18, 2003

CALIFORNIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM
PETER H. MIXON
PATRICIA BURGESS
MARTE E. CASTAÑOS

PETER H. MIXON

Attorneys for Plaintiff